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The world economy is still relatively strong—but don't bet your house on it: leader

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Politics this week

May 25th 2006
From The Economist print edition

AP

After six months of negotiation, **Iraq's** parliament endorsed a united government of Shias, Sunni Arabs and Kurds, led by Nuri al-Maliki, an Islamist from the dominant Shia alliance. The main Sunni Arab party has a clutch of ministries, raising hopes that it will persuade at least some of the insurgents to negotiate. The crucial defence and interior ministries are still waiting to be filled. See article

Ehud Olmert, **Israel's** prime minister, met President George Bush in Washington, where they agreed that Iran should be prevented from getting nuclear weapons. Mr Bush said America would “come to Israel's aid” if Iran attacked, and he praised Mr Olmert's “bold” plan to adjust Israel's borders unilaterally if attempts to agree them with the Palestinians failed. See article

Mahmoud Abbas, the Palestinian president, said he would call a **referendum** unless Hamas agreed to accept the pre-1967 borders of Israel. This came after violence between his Fatah faction and Hamas cost several lives in the Gaza Strip.

Lakhdar Brahimi, a UN official, went to **Sudan** to try to persuade the government in Khartoum to let a UN peacekeeping force into its western Darfur region. Violence has persisted there since a peace deal between the main rebel group and the government was signed three weeks ago.

In a tense run-up to elections due on July 30th, the government has told politicians in the **Democratic Republic of Congo** that they should not have more than 25 bodyguards each.

Zimbabwe's inflation rate exceeded 1,000%. When Robert Mugabe came to power in 1980, Zimbabwe's dollar was worth $1.60; an American dollar is now officially worth 100,000 Zimbabwean dollars. See article

Fears over bird flu

The World Health Organisation expressed concern about a cluster of recent human deaths from the H5N1 strain of **bird flu**. Seven people from the same Indonesian family have died from the disease with no apparent sign of animal infection, raising the possibility of human-to-human transmission. See article

Australia is deploying troops to calm **Timor-Leste**, where violence has erupted in the capital, Dili. The unrest started with the sacking of soldiers, who had gone on strike. The president, Xanana Gusmao, said that security was now his personal responsibility.

Thaksin Shinawatra, chaired his first cabinet meeting since stepping aside as prime minister of **Thailand** seven weeks ago. Fresh elections have been ordered since a poll on April 2nd was annulled, but no date has yet been set. It is unclear who exactly is running the country at present.

Afghanistan's government claimed to have killed up to 60 Taliban militants in a battle in the central province of Uruzgan. Fighting has intensified recently in many parts of the country, reaching levels not seen since the American-led invasion of 2001.

China completed work on the main wall of the Three Gorges dam. A vast feat of engineering, the dam has caused much environmental controversy. See article

Friendly fire

In **Colombia**, an army patrol killed ten members of an elite police drug squad and their civilian informant in what officials said was an accident. The incident was a blow to the government of Álvaro Uribe, who was expected to win a second term in a presidential election on May 28th. See article

Vladimiro Montesinos, **Peru's** jailed former spy chief, told a court that Ollanta Humala, a candidate in next month's presidential run-off, helped him escape from the country six years ago by staging a fake military rebellion. Opinion polls give Alan García, a former president, a 15-point lead over Mr Humala.

René Préval, **Haiti's** new president, appointed Jacques Edouard Alexis as his prime minister. Mr Alexis, formerly a university rector, held the same post from 1999 to 2001 during Mr Préval's previous presidency.

Nagin in again

EPA

Despite strong criticism of his handling of the aftermath of Hurricane Katrina, Ray Nagin was narrowly re-elected as mayor of **New Orleans**. He won 80% of the black vote.

American congressmen bridled over an FBI search—the first in history—of the office of a sitting congressman, who had been taped accepting a $100,000 bribe. They claimed it was a breach of separation of powers and of congressional prerogatives. **William Jefferson**, a Democrat from Louisiana, had stored most of the cash in his freezer. See article

America's **Supreme Court** refused to hear an appeal against the combination of drugs used to execute criminals by injection, thereby allowing the practice to continue. A prisoner in Tennessee had claimed that one of the drugs caused such intense pain that it amounted to “cruel and unusual punishment”, which is banned by the constitution.

Balkanisation

AFP

In **Montenegro**, 55.4% of those who voted supported independence from Serbia. Theirs will be the first new country in Europe since Slovakia in 1993. Both Montenegro and Serbia want to join the European Union as soon as they can. See article

Spain's prime minister, José Luis Rodríguez Zapatero, declared that he was preparing for talks with ETA, a Basque separatist group. ETA, which has killed more than 800 people in the past three decades, declared a permanent ceasefire in March.

In a parliamentary election in (Greek) **Cyprus**, voters strongly backed parties hostile to the idea of reviving the UN unification plan that was rejected in 2004. A solution to the Cyprus problem looks as far off as ever.

Italy's new government said that the country's budget deficit was worse than it had feared. A deputy economics minister suggested that it might be over 4.5% of GDP this year. The chances of getting it below 3% by 2007, as promised, now look remote.

In two unrelated but worrying accidents in the **Aegean** region, a Turkish and a Greek fighter plane collided in mid-air, killing the Greek pilot, and a huge fire engulfed the cargo terminal at Istanbul's Ataturk International Airport, injuring three workers.

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Business this week

May 25th 2006
From The Economist print edition

Stockmarkets endured another uneasy week. Shares in Britain and mainland Europe were volatile, and fell heavily in emerging markets such as Russia, India, Turkey and Indonesia. Investors sought refuge in American Treasury bonds, which strengthened over the week, not least because figures showing weak April orders for durable goods raised the chances that the Federal Reserve will pause before lifting interest rates again. See article

Euronext's managers and shareholders weighed rival bids for the company, which runs stockmarkets across Europe and a derivatives exchange in London. The managers endorsed an offer from the New York Stock Exchange in preference to the Deutsche Börse, another big European exchange. The shareholders remained non-committal, hoping for sweetened offers. See article

After a three-year investigation, regulators concluded that **Fannie Mae**, which underwrites American mortgages, had indulged in "fraudulent accounting". It will pay $400m to settle the case, but its former executives may still face charges for misreporting profits so as to fatten their bonuses. These ill-gotten gains should be reclaimed by the company, its federal regulator said. Its mortgage holdings will also be frozen at $727 billion, their December 2005 level, until it cleans up its act. See article

Sir Ken Morrison agreed to step aside as chairman of Wm Morrison, ending a boardroom battle that followed the British retailer's purchase of Safeway in 2004.

Aid or IPO?

Bank of China, China's second-largest bank, raised $9.7 billion from its initial public offering, the biggest in the country's short experience of financial markets. If demand is strong enough, the bank may offer more shares, to raise another $1.5 billion. In London, however, two other listings were postponed amid the markets' jitters.

Bertelsmann agreed to pay €4.5 billion ($5.75 billion) for a 25.1% stake owned by Groupe Bruxelles Lambert. The Belgian investment house had threatened to list its holding in the German media group. See article

The **World Bank** decided it still has a role to play in China, a country with dollars aplenty, but also with more impoverished people than any other country except India. The bank will lend up to $1.5 billion a year over the next five years.

Rosneft, an oil company the Russian government wants to sell, reported profits of $4.2 billion for 2005. Its revenues flowed largely from its Yuganskneftegaz production arm, which belonged to Yukos, a private company dismembered by the tax authorities. See article

OMV, central Europe's biggest oil and gas company, caved in to political resistance over its proposed merger with **Verbund**, Austria's largest electricity supplier. The sale of the company, controlled by the government, would not have been "meaningful and just" (ie, politically palatable), said Austria's economics minister.

A Dutch court passed verdict on "Europe's Enron", the 2003 accounting scandal at **Ahold**, a huge food retailer. Its former boss, Cees van der Hoeven, and his finance director were convicted of fraud. Each now faces a fine of €225,000 ($287,400) and a nine-month suspended sentence.

Babcock & Brown, an Australian investment company, agreed to buy **Eircom**, Ireland's biggest telecoms company, for $3.1 billion. The Australians will be the former state monopoly's fifth owner since it was privatised in 1999.

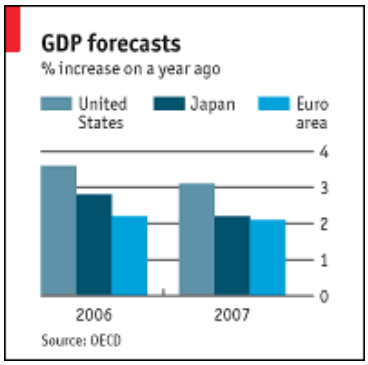
Valcon Acquisition, a group of six private-equity companies, triumphed at last in its three-month campaign to buy **VNU**, a Dutch market-research company. Valcon said it now has 78.7% of the company's shares, and gave remaining shareholders until June 9th to sell the rest.

Vonage, an internet-based phone company, raised $531m in its initial public offering, charging $17 a share, only to see its stock end the first day of trading worth only $14.85. See article

Free speech

In testimony to the Senate Banking Committee, **Ben Bernanke**, chairman of the Federal Reserve, admitted that he had suffered a “lapse of judgment” when he told a journalist at the White House correspondents' dinner last month that he was not as doveish on inflation as financial markets thought.

In its twice-yearly economic outlook, the **OECD** forecast that growth this year would be 3.6% in America, 2.2% in the euro area and 2.8% in Japan. Growth in all three areas is expected to slow slightly in 2007. Remaining slack in the American and Japanese economies is forecast to disappear by the end of next year, but “ample excess supply” will remain in Europe.



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The markets and the world economy

Bears in the woods

May 25th 2006
From The Economist print edition

Despite the rattled markets, the world economy is still relatively strong. Just don't bet your house on it

Nature

IF YOU meet a bear in the woods, try not to panic or scream; on no account should you turn your back and run. As markets around the world have turned grizzly over the past two weeks, some investors seem to have forgotten the old hikers' maxim. After three years of big gains, many stockmarkets have tumbled by 10% or more in less than ten days. The loudest growls have echoed around emerging markets and commodities. Europe has surrendered most of this year's gains. Americans have so far escaped lightly, but they would be unwise to take comfort. Their housing market, the recent rock of their economy, is where a much grizzlier creature lies in wait.

Most investors tend to look first at equity markets—and they have certainly had a good run virtually everywhere. Yet a repeat of the slump after the bursting of the dotcom bubble in 2001-02 remains highly unlikely. In 2000 shares were wildly overvalued. Today price/earnings ratios in most stockmarkets are near, if not below, their long-term averages. This suggests that the slide in shares could be short-lived.

So what has caused this burst of volatility? One popular explanation conjures up fears of rising inflation and hence higher interest rates (see article). Yet this sits oddly with the fall in bond yields and the gold price over the past week: if inflation were the culprit, you would expect both to have risen. The real puzzle is not why volatility has suddenly increased, but why it had been so low in the past year or so. The answer seems to be an abundance of cheap money, which lured investors into complacency. Now they are starting to demand higher returns on riskier assets. Emerging-market equities and metals, not (generally safer) bonds, suffered the biggest mauling in the past week. It could be a healthy correction.

A formidable machine

Indeed, the recent jitters need not harm the world economy, which even bears admit has performed stunningly. World GDP has grown at an annualised rate of more than 4% for 11 consecutive quarters (see our economic and financial indicators). This is the strongest upturn for more than 30 years. Yet global inflation remains historically low. Strong growth with mild inflation is all the more amazing given the tripling of oil prices since 2003. Past oil-price shocks have caused stagflation.

The world has so far shrugged off higher oil prices with the help of two powerful economic forces. The first is the opening up and integration into the world economy of China, India and other emerging economies. This has given the biggest boost to global supply since the industrial revolution. Their cheap labour has cut the cost of goods. The threat that jobs in rich economies could move offshore has helped hold down wages. Although demand from emerging economies has fuelled the surge in oil and commodity prices, the newcomers' overall effect has been to curb inflation in the rich world.

That, in turn, has magnified the second stimulus. Since the bursting of the dotcom bubble, central banks have

pumped out cheap money. In 2003 average short-term interest rates in the G7 economies fell to their lowest in recorded history. Because inflation remained low, the central banks have been slow to mop up the excess liquidity. Cheap money has encouraged households, especially American ones, to borrow and spend lavishly. It is not just house prices that have surged ahead; cheap money has encouraged investors across the world to take bigger risks, creating several smaller bubbles. Together the huge boost to supply (from emerging economies) and the huge boost to demand (from easy money) have offset the burden of higher oil prices, creating the once-impossible combination of robust growth and modest inflation.

Don't panic

The era of cheap money is nearing an end. For the first time in 15 years, the three big central banks are now all tightening monetary policy. The European Central Bank has already followed the Federal Reserve's lead in raising interest rates; the Bank of Japan has stopped printing lots of money and will start lifting rates soon. Only now are the markets realising that interest rates may rise by more than they had expected. In the long term, rates should be roughly equal to nominal GDP growth, but in America and elsewhere they are still well below it. Optimists argue that America's economy is coping well with rising interest rates, but it hasn't really sniffed tight money yet. Without easy credit, dear oil will cause more pain.

Until recently, financial markets appeared to be betting that the Goldilocks economy—neither too hot, nor too cold—was safe from the bears. The rattled markets are a reminder that sooner or later growth will slow or inflation will rise. Inflation is not about to spiral upwards but with diminishing spare capacity, it could edge up. America has an extra risk because Wall Street suspects that Ben Bernanke, the Fed's new chairman, may be a soft touch on inflation. If that suspicion persists, he will need to raise interest rates by more than otherwise—or investors will do the tightening for him by pushing up bond yields. That would make other assets look expensive.

It is in the American housing market that the bear may growl loudest. By borrowing against the surging prices of their homes, American consumers have been able to keep on spending. The housing market is already coming off the boil (see article). If prices merely flatten, the economy could slow sharply as consumer spending and construction are squeezed. If house prices fall as a result of higher bond yields, the American economy could even dip into recession. Less spending and more saving is just what America needs to reduce its current-account deficit, but for American households used to years of plenty it will hurt.

For the world, it is best that America slows today. Later, imbalances will loom even larger. A few years ago, Japan and the euro-area economies were flat on their backs. Now they are growing “above trend”, so the world depends less on America than it once did. The boost to the world economy from China and India will last into the future, even allowing for mishaps. Wise investors should resist the urge to flee, reduce their holdings of risky assets and stare down the bear.

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Russian oil

Thou shalt not steal

May 25th 2006
From The Economist print edition

Western investors should not endorse the Kremlin's rapacity

Reuters

Get article background

THE first time the Kremlin privatised Russia's oil industry was a tragedy. Capitalism was shamed as Mikhail Khodorkovsky and other “oligarchs” grabbed giant firms in rigged auctions in the 1990s. Under Vladimir Putin history has repeated itself as farce. The Kremlin's campaign against Mr Khodorkovsky and Yukos, once Russia's leading oil firm, has been economically damaging and politically embarrassing. The final act in this sordid drama will be the listing by Rosneft, a state-owned oil company that bought most of Yuganskneftegaz, Yukos's main subsidiary, through another dodgy auction at the end of 2004. Rosneft and the Kremlin are hoping that the listing, due in July, will legitimise their tactics and their hold on the assets. Western investors should not oblige them.

The Kremlin's behaviour towards Yukos was wrong, extra-judicial and bad for Russia. There was a case for seeking some sort of compensation for the huge discounts and exorbitant profits that Mr Khodorkovsky and others had enjoyed. And there was a certain poetic justice in the way Yugansk was renationalised. But poetic justice is not real justice. If it is ever to become a democratic country with a functioning market economy, Russia needs stable property rights and an impartial legal system—just what Mr Putin promised when he came to power. Instead, he made an example of Yukos, overseeing a capricious application of the law that reversed improvements in the judiciary and fostered corruption. The pursuit of Yukos also transferred a mainstay of the economy from what had become an efficient private business to opaque state control.

As forlorn minority shareholders in Yukos can attest, western investors would also benefit from property rights and decent courts in Russia. Still, when a chunk of Rosneft comes up for sale, the temptation for them to set all that aside will be strong (see article). Western involvement, some may argue, could help to clean up Rosneft—which has a history of favouring insiders over everyone else—and, eventually, Russia itself. Others may conclude Russian oil is too lucrative to ignore. Indeed, if many investors abjure the listing, those who hold their noses and take the plunge might make even more money.

Rosleft

In fact, prospective buyers inclined to heed their consciences should do so—because the listing has commercial perils as well as moral ones. Contrary to appearances, political competition does take place in Russia; but it is to be found inside the Kremlin. Although the clique of advisers allied to Rosneft is now ascendant, that may change after Mr Putin leaves office in 2008. Presidential successions can have unexpected consequences, as discovered by Mr Khodorkovsky, now suffering “accidents” in a Siberian labour camp. Rosneft may face lawsuits from assorted Yukos shareholders, something the planned London listing may make easier. Lastly, there are the risks of buying

into a state-controlled Russian energy company. Rosneft now says that although it belongs to the state, its management is independent and it is more single-mindedly commercial than Gazprom, the state-controlled gas giant. But the Kremlin will almost certainly determine Rosneft's strategy.

Since the fall of communism, Russian businessmen, including Mr Khodorkovsky, have repeatedly gambled on the amnesia of foreigners—betting that the greed of investors and a bit of public relations would obscure memories of malfeasance and instability. In general, they have been vindicated. Just as in Soviet times rivals and renegades were airbrushed out of photographs, Rosneft and the Kremlin are now hoping that what they did to Yukos can be erased from history. This time, the gamble should fail.

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The future of Europe

Stuck in the doldrums

May 25th 2006
From The Economist print edition

One year after the French non and the Dutch nee, it is time to bury the EU constitution

Get article background

IT ALWAYS takes time to recover from a shock. That certainly seems true of the European Union since French and Dutch voters decisively rejected the draft EU constitution in a pair of referendums a year ago. For most of the past year the mood across the continent has been deeply gloomy.

The gloom reflects a variety of worries. From Britain to Italy, political leaders of all stripes have been discredited or voted out of office. Most economies have been weak and unemployment has stayed high. Cities (and suburbs) have been convulsed by protests, riots or terrorism; fears of radical Islam have mounted. In foreign policy, Europe has been uncertain in its dealings with a resurgent Russia; and its attempts to stop Iran going nuclear seem to be coming to nothing.

Set against such concerns, the fate of the EU constitution seems trivial. Yet during the past year's “pause for reflection”, plenty of ideas have been put forward by the continent's leaders. In mid-2004 a consensus painfully emerged among national governments in support of the constitution. This time no deal is in prospect (see article). The main obstacle is that many members insist that the constitution, which will soon have been ratified by 16 of the 25 EU members, can be resurrected. Their hope is that the French and Dutch will vote again; and that other countries that are hanging back, such as Britain, Poland, Denmark and the Czech Republic, can then be prodded into holding their own referendums.

Yet the idea of putting the constitution to French and Dutch voters again is preposterous. Unlike previous treaties, it cannot be amended to give the two countries an opt-out. There is no reason to believe that voters' objections have disappeared—if anything, the EU is less popular today than it was a year ago. Moreover, underlying those objections was a belief that the European project has been carried forward by an elite that has paid little heed to the views of ordinary people. It would be a travesty of democracy for the elite now to order the people to keep voting until they give the “right” answer.

Start thinking about tomorrow, not yesterday

A better course would be for Europe's leaders to forget the constitution and concentrate on their much bigger worries. Top of the list must be improving their sclerotic economies, best done through a serious programme of liberalisation and deregulation. Linked to this should be the preservation of the single European market and its competition rules, which are under attack from economic nationalists. In these areas the European Commission has become a helpful proponent of economic liberalism and even of tearing up red tape, but it needs much firmer support from national governments, especially in France, Germany and Italy.

The other priority for the union ought to be continuing with its expansion plans. The enlargement of the club to

take in new countries to its south and east has been one of its greatest successes. Even now, it is only the lure of membership that keeps such places as Turkey and the western Balkans on the path towards being decent liberal democracies. The latest kid on the block is Montenegro (see article)—and the top priority of this new country is, predictably, to join the EU.

At this point, true believers raise the constitution again. Without it, they argue, the EU of 25 (soon to be 27) can no longer function effectively. In any case, a new treaty is required before Croatia joins, since its votes and parliamentary seats were not fixed under the 2000 Nice treaty. They conclude that, without the new constitution (or something like it), enlargement of the club, and indeed its functioning, will grind to a halt. Yet these arguments are tendentious. For all its faults, the EU has worked over the past year. Membership talks have begun with Croatia and Turkey; a start has been made on an energy policy; a budget deal, however unsatisfactory, was struck for 2007-13. Yes, a new treaty will be needed for Croatia and other applicants, but it could easily be a one-page text that simply rejigs votes and seats, not a full-blown constitution.

Besides, any large-scale treaty now has to be approved by referendum in several countries, so the union should face the possibility that it may never get one. That need not be a disaster. Since 1990 Europe has been almost continuously preoccupied by inter-governmental conferences and new treaties to tinker with its institutional architecture. Yet the EU's real failing is not a democratic or institutional deficit—it is what the Centre for European Reform, a London think-tank, has termed a “delivery deficit”. After all, if a club cannot deliver benefits to its members, they may decide to scrap it altogether.

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Iraq's new government

At long last

May 25th 2006
From The Economist print edition

Although Nuri al-Maliki is an improvement on his predecessor, he will struggle to succeed

AP

Get article background

THE sectarian carnage in Iraq is now so relentless and the murderous tit-for-tat so ferocious that it would be foolish to emit whoops of joy at the news that a national-unity government has at last been agreed upon. The country still seems bent on flying apart along ethno-religious lines that are both blurred and bloody, especially in Baghdad. Ethnic cleansing is proceeding apace. The fact that the two crucial ministries in the new government—defence and interior—have been temporarily handed to acting ministers because of last-minute wrangles bodes ill for the new government's cohesion before it has even begun to function (see article). Meanwhile the American administration, despite its protestations to the contrary, sounds keener than ever to bring its troops home—even though their premature return could speed the onset of a full-scale civil war which would mark down George Bush's Iraqi venture as one of America's greater foreign-policy failures.

So the backdrop is bleak. Yet the formation of a new government is still a step forward. And everything must be done—by Iraqis and by outsiders, in the West and in neighbouring Arab and Muslim countries—to give the new prime minister, Nuri al-Maliki, a chance to stem the tide of chaos, to beat back the insurgency, and to give ordinary Iraqis a better life. The odds are against these things happening; but there is a little more hope this week than last.

To begin with, Mr Maliki promises to be an improvement on his bumbling predecessor, Ibrahim al-Jaafari. Although hailing from the same Islamist-minded Shia party, the new man has called for tolerance and compromise, says his ministers have been chosen for their competence rather than their religious or ethnic links, and agrees that the militias should be dismantled and their followers absorbed into a new-look national police and army. Even if he has yet to appoint an interior minister, it is still good news that he had sidelined the previous incumbent, a Shia seen by Sunnis as a sectarian killer. It will be good news, too, if and when a Sunni Arab with genuine support in his own community is named as defence minister, with at least a chance of persuading the more nationalist insurgents, as opposed to the al-Qaeda-minded suicide bombers, that their aims can be achieved by peaceful politics. It is anyway good that parliament's biggest Sunni group, with a proper mandate from Iraq's disaffected Sunni Arabs, is well represented in the new team.

While applauding Mr Maliki for building a government that crosses sectarian lines, it must also be admitted that the nice-sounding notion that ministers have been chosen on merit is largely untrue. Mr Maliki has dished out his portfolios virtually by quota, and ministries will probably be regarded by whichever parties control them as milch cows of patronage (though the oil ministry has been wisely placed in the hands of an impressive Shia technocrat). Likewise, the ideal of dissolving the militias or inducting them into regular national forces is unlikely to be fulfilled any time soon. The best that can be hoped is that they will be somewhat reined in.

Face the truth

The bigger hope, as the new government gets going, is that Iraqis will gradually come to accept a wider measure of decentralisation in a loose federation. Alas, the long-oppressed Shia majority has yet to accept that it cannot assert untrammelled power over its former Sunni masters, while the Sunni Arabs have yet to accept that they make up barely a fifth of Iraqis with no God-given right to recover their former dominance. The smiling Kurds, for their part, now seem increasingly likely to retain their extreme autonomy in the north; most Sunni and Shia Arabs, in a rare convergence of views, have apparently grown to accept that they can no longer corral the Kurds within a centrally run Iraq and that the Kurds are likely now to win the lion's share of the disputed, oil-rich province of Kirkuk.

The real fight now is not between Americans and Iraqis—though they are still killing each other—but between Iraq's Shia and Sunni Arabs. If Mr Maliki is to have a hope of winning over enough Sunnis to dampen their insurgency, he must move fast to tweak the constitution to reassure them that they will get a fair distribution of oil revenues and to limit the scale of a mooted Shia “super-region” in the centre and south that would seem to leave the Sunnis with only a poor rump of their once-vaunted Arab nation. Despite his four-year mandate, Mr Maliki probably has less than a year to turn the tide. If he fails, Iraq's three main communities will continue their slide into a Lebanese-style civil war.

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Indonesia after Suharto

An understated success

May 25th 2006
From The Economist print edition

Their former dictator is gravely ill. Indonesians have come a long way since his fall

AP

Get article background

THE passing of a former dictator sometimes forces a country to take stock of itself. So it is with Suharto, who for 32 years towered over the world's most populous Muslim country. As his life moves peacefully to its close, Indonesians seems baffled about how to think about the old despot. Many millions revere him as the man who saved them from communism and led his country towards prosperity. Many more Indonesians see him as a dictatorial kleptocrat whose family looted the nation, whose goons harassed and tortured dissenters, and who clung stubbornly to power until being forced out in 1998 by a huge, but blessedly peaceful, popular revolt.

There is truth, of course, in both accounts, which is in part why the government of Susilo Bambang Yudhoyono has seemed so uncertain how to treat the old man. Until recently, it was still investigating him for corruption. But on May 12th, as Mr Suharto seemed near to death, the attorney-general abruptly declared that the government was dropping all criminal proceedings against him. Now it is said that the government is considering the possibility of bringing civil charges for corruption against him instead—though given Mr Suharto's health any investigation would be purely symbolic.

Mr Yudhoyono's ambivalence towards the dictator is symptomatic of a big flaw in his administration: a reluctance to give Indonesia a true culture of accountability. Mr Yudhoyono served as a general in the Suharto years and has trodden carefully when confronting the worst excesses of that time. Neither Mr Suharto nor any of his family has been put on trial for corruption (though his son, Tommy, was jailed on a murder charge before Mr Yudhoyono took over). Nor has there been a determined attempt to bring to justice those army officers who oversaw atrocities in East Timor and Irian Jaya (now known as Papua) after Mr Suharto fell, let alone those who committed them while he was still in power. To be fair to Mr Yudhoyono, his three predecessors also failed to grasp this nettle and some lowlier officials have recently been rightly fired. But as the first directly elected president in Indonesia's history he has had the legitimacy, and the duty, to do better.

For all that, Mr Yudhoyono's cautious and consensual style has served Indonesia well. His greatest achievement has been to help bring what increasingly looks like a permanent peace to Aceh, a separatist province on the island of Sumatra, which has been fighting for independence for 30 years. Tension in Papua, at the other end of the Indonesian archipelago, has spiked in the past few months, but even there things are quieter than they were in the early years of this decade. Radical Islamism, though hardly eradicated, has calmed down markedly, thanks to good police work and tough courts. All of these things started to go right under Mr Yudhoyono's predecessor, Megawati Sukarnoputri, but he was her security minister.

A nice little earner

In the economic arena, Mr Yudhoyono has been equally impressive, despite a slow start after his election in September 2004. He now has a decent economics team, and he personally unblocked a tottering deal between the state-owned energy company, Pertamina, and America's Exxon by replacing Pertamina's top management. Other big deals are being negotiated, helped by the perceived stability and relative integrity of the government. Last October Mr Yudhoyono even dared to cut Indonesia's costly oil subsidies. He has kept growth steady at around 5% a year, and the rupiah strong.

None of this (see article) is irreversible. Indonesia has its fragilities. But as they take stock of a painful past, its people can take pride in recent achievements. In a giddily short space of time, they have built a plural democracy, where Islamist parties can fight (and lose) elections peacefully, and where the army at last accepts civilian rule. Indonesia is a steady economic performer and an increasingly attractive destination for investment. However history judges Mr Suharto, the Indonesia of today has become, in its understated way, a success.

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On Turkey and the EU, trade and Brazil, Europe and Islam, Congress, xenophobia in Russia, music online, Google, Singapore's election

May 25th 2006
From The Economist print edition

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FAX: 020 7839 2968 E-MAIL: letters@economist.com

Turkey and the EU

SIR – Despite being a staunch and informed supporter of Turkey's full membership in the European Union, you seem now to conclude that Turkey is moving away from Europe ("Flying in the wrong direction", May 6th).

I very much disagree. A comparison with only four years ago would go a long way in explaining how Turkey has in fact been moving into the core of Europe. Just consider how many taboos have disappeared from the scene in Turkey. The *acquis* of the EU is being adopted, and our accession process has so far been much less problematic than expected by some. The European Commission has praised the performance of our team.

Additionally, we are creating and sustaining this dynamism on the heels of one of the most successful economic stories of our time. Turkey has grown by no less than 35% in cumulative terms in the last four years, substantially decreasing the difference in economic performance that exists between it and the EU.

Turkey's commitment to the process of accession is as firm as ever. Notwithstanding a certain reticence we encounter in parts of Europe, those who desire to see Turkey fully integrated in Europe are more steadfast. In fact, I see your newspaper as being at the forefront of that effort, as you end your analysis on the right note, by wisely calling on Europe's leaders to reassure Turkey. I hope your call will be heeded.

Abdullah Gül
Deputy prime minister and minister of foreign affairs
Ankara, Turkey

Trade and Brazil

SIR – It is a factual error to assert that Brazil's decision "to stress relations with countries in Africa, the Middle East and Asia" has yielded "meagre results" ("The diminishing of Brazil", May 13th). Between 2002 and 2005 Brazilian exports to Africa rose by 153% and imports from Africa by 149%. With the Middle East the increases were 84% and 75% respectively, and with Asia 111% in both cases. The total value of Brazil's exports to these regions rose from $13.4 billion to $28.8 billion, while imports increased from $12.1 billion to $26 billion.

Brazil's total exports in this period virtually doubled (from $60.3 billion to $118.3 billion), due mainly to the expansion in trade with the developing world. These countries absorbed 43% of Brazilian exports in 2002, but by 2005 the figure had risen to 53%.

Ricardo Neiva Tavares
Press secretary
Ministry of Foreign Affairs
Brasília, Brazil

Bring me your unfree

SIR – The suggestion that Europe may lack a "robust culture of free speech and free personal behaviour" is an understatement ("Heading for the land of the free", May 20th). More accurately, Europe's citizens must assume a posture of deference to Islam, or forfeit their lives. Now the dissidents are leaving. We in America welcome free spirits like Ayaan Hirsi Ali. Send us more!

John Barker
Reno, Nevada

Bush and Blair

SIR – Is the root of America's problems at home and abroad truly “incompetent execution” on the part of its current president (“Axis of feeble”, May 13th)? I think not.

We Americans gave up on the myth of a single, competent ruler over 200 years ago. Our problem is a feeble, incompetent Congress that has shirked its responsibility to ensure that the executive branch of government does not become too powerful. What we Americans need is not a strong John McCain or Hillary Clinton. We simply need our Congress back.

Roger Brewer
Honolulu, Hawaii

SIR – George Bush and Tony Blair may have had their day, but they set in motion a series of events that cannot and should not be reversed. The events of September 11th have defined the 21st century in the same way that the shot heard around the world in 1914 defined the 20th century. Mr Bush and Mr Blair looked to the future, didn't like what they saw and decided to do something about it.

Roy Weston
Vancouver, Canada

SIR – Please do not ever mention George Bush. And Winston Churchill in the same sentence again, even if you must break all the rules of grammar to do so.

Steve Pettit
California

San FranMoscow

SIR – You suggest that St Petersburg “rivals Moscow as the capital of race hatred” in Russia (“Playing a dangerous game”, May 13th). As anyone who has spent time in the more remote parts of Russia will attest, Moscow and St Petersburg are by far the most tolerant and cosmopolitan cities in Russia. Even though they are less well documented, the levels of xenophobia in places like Novokuznetsk and Voronezh make Moscow seem like a Slavic version of San Francisco for groups at risk.

Vanessa Rampton
Geneva, Switzerland

Download depression

SIR – There is nothing particularly forward-looking about Jimmy Iovine's defence of a flat rate of 99 cents per song (Face value, May 6th). By siding with Apple against the other major labels on variable pricing for music online, Mr Iovine may well be shooting himself in the foot. For the first time, the music industry is in a position to maximise revenue with megastar releases selling at a higher price than the music of lesser-known artists.

In the offline world, competition between retailers has pushed prices down to a uniform low level. With Apple's iTunes becoming almost a single point of sale for online music, variable pricing could, at last, help the recording industry by better reflecting demand. Even if that move proves somewhat unpopular with younger consumers, research by IPSOS and others suggests that the online market is being colonised in droves by older folks.

Peter Alhadeff
Berklee College of Music
Boston

A Googly

SIR – Google seems to be following the same line Ronald Reagan took with the Russians in the 1980s (“Is Google the new Microsoft?”, May 13th). Reagan speeded up the break-up of the Soviet Union by forcing it to spend beyond its means on weaponry to defend against perceived, but actually unreal, threats such as the Star Wars programme.

In much the same way, Google is throwing up many cheap-but-flashy initiatives that force Microsoft to spend huge sums in order to contain perceived, but probably illusory, market threats. Can we not anticipate the same outcome: the break-up of software's acknowledged evil empire and the emergence of its captive technologies into the world of fair competition?

Alan Tobey
Berkeley, California

Prosperous or free?

SIR – Mr Lee Kuan Yew judges the strength of a country by its economic prosperity ("A rational choice", April 22nd). Other people prefer to do it by its people's liberty.

Katha Chalotorn
Bangkok

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Europe's future

A venture at a standstill

May 25th 2006
From The Economist print edition

Twelve months after the French and Dutch said no, the European Union has yet to rediscover its purpose

Get article background

AS CHOU EN-LAI observed of the 1789 revolution in France, the full impact of events in that country can take centuries to discern. That may yet prove true of the French no to the European Union's draft constitution, expressed in a referendum on May 29th last year. But there was no doubting the shock, especially when it was amplified three days later by an even bigger no from the Dutch. For the first time since a European common market was set up in 1957, two of the six founders of the club had decisively rejected a step in the long march towards fuller integration.

Ever since, Europe's leaders have been unsure what to do next. The immediate gloom was deepened by one of the EU's periodic budget squabbles, prompting Jean-Claude Juncker to declare that “Europe is not in crisis: it is in a deep crisis.” As Luxembourg's prime minister, he spoke with authority: his country was then president of the European Council, the group of national leaders who together are the ultimate decision-makers in the EU. Discombobulated summiteers hurriedly agreed to a “pause for reflection”.

A year on, what has the pondering brought forth? There have been speeches galore, by such luminaries as Britain's Tony Blair, France's Jacques Chirac and, most recently, Germany's Angela Merkel. The European Commission, the EU's policy-proposing executive, has produced not a plan B but a plan D (for democracy). Its president, José Manuel Barroso, has issued many papers. Belgium's prime minister, Guy Verhofstadt, has even written a book. And yet, as EU foreign ministers meet to discuss the constitution this weekend, before a summit under the Austrian presidency, the answer to the question is: precious little. The summit will simply extend the pause for reflection for another year.

After such a shock, it was perhaps inevitable that a year would not be enough. But three other problems have increased the EU's paralysis since last May. The first is a familiar lack of leadership, exacerbated by the electoral cycle. After a tight election in September, Ms Merkel replaced Gerhard Schröder as German chancellor only last November. After an almost equally narrow win in April, Romano Prodi has only just become Italy's prime minister in place of Silvio Berlusconi. Meanwhile France is going through the drawn-out dénouement of Mr Chirac's 11-year-old presidency. He is now so feeble politically that little can be expected in the way of fresh EU initiatives until he leaves office next May.

The second problem is that nobody agrees about the reasons the French and Dutch said no. Eurosceptics were swift to hail the votes as a rejection of the drive towards ever-closer union that had, they said, been foisted on reluctant voters by the European elite for 50 years. Euro-enthusiasts were just as quick with a very different

interpretation: that the voters wanted more Europe, to increase social protection and to keep at bay the excesses of free markets. Still others thought the voters were merely taking the chance to bash unpopular national governments.

What seems certain is that the naysayers were not rejecting the EU constitution as such: few could have mastered such a complex text, and fewer still could have grasped how it differed from existing European treaties. Rather they were showing dissatisfaction with the European project in a wider sense. The no campaigns played on fears of globalisation, on slow growth and on high unemployment. These feelings found expression in hostility to the expansion of the union to take in low-wage countries to the east, and to plans for more liberalisation of energy markets and trade in services. Yet none of these was directly linked to the constitution.

Unlike the first two problems, the third was self-inflicted. This was the refusal of many governments to draw the clearest conclusion from the two noes: that the constitutional treaty was dead. Countries that had already ratified it were understandably loth to give it up. Much stranger has been the spectacle of six more countries solemnly ratifying the text even after last May. Luxembourg did it by referendum in July. The others put it through their parliaments. Finland is expected soon to become the 16th of the EU's 25 members to give it final approval.

Any EU treaty has to be ratified by all members before it can come into force. Yet those who still want to press ahead with the constitution point to two previous experiences. In 1992 Denmark's voters turned down the Maastricht treaty; and in 2001 the Irish threw out the Nice treaty. After each rejection the treaty was slightly titivated, with various declarations or opt-outs added, after which the voters were asked to pronounce again—and then they said yes. It was also noted that the constitution itself envisaged that ratification might be difficult in some countries. A declaration attached to the text provided that if, within two years of the treaty's signature, four-fifths of the members had ratified it but some had not, the European Council should meet to consider what to do.

Carry on regardless

The implication of this declaration, some have argued, was that a rejection by one or two of the EU's members should not deter the others from proceeding. Only after every country had had its say would it be right to discuss the next steps. The unspoken assumption was that, if only one or two had jibbed at the text, some way would be found of getting them to vote again and say yes. To make that look more plausible after the no votes, it was also noted that elections were due in 2007 in both France and the Netherlands.

Yet a moment's consideration shows that dreams of proceeding with the constitution are utterly unrealistic. It contains nothing that could be adjusted to give France or the Netherlands opt-outs. And, anyway, there is something undemocratic about asking electorates to endorse a text and, when they deliver a resounding no, asking them again. No French or Dutch leaders, now or in prospect, have floated the idea of putting the constitution to a fresh vote (though France's Valéry Giscard d'Estaing, who presided over the constitutional convention, has suggested it). Besides, six countries—Britain, Ireland, Sweden, Denmark, Poland and the Czech Republic—have made clear that, after the French and Dutch votes, they have no plans to ratify the constitution. Most of these had promised referendums.

One sensible thing that next month's summit could do is to agree to forget the present text. That would enable the summiteers to move on to the more fundamental questions that the constitution was supposed, but failed, to answer: how to restore the EU's purpose (and, just as desirable, its popularity), and what institutional changes this might require.

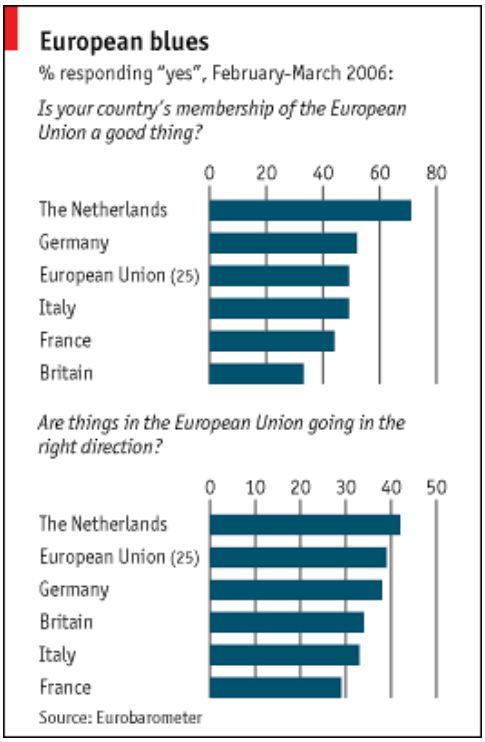
What is wrong with Europe? The main answer is, as it has been for some years, the economy. Especially but not only in the core euro countries of Germany, France and Italy, growth has been sluggish, at best. In many countries unemployment seems both high and stuck. The morosity that underlay the French and Dutch noes was primarily about growth and jobs.

Not surprisingly, the constitution, which was meant to be about the efficiency and organisation of the EU, offered little on the economy. The prime responsibility for getting economies growing again remains national, not European—a point that is obvious when you contrast the performance of Britain and Spain (average growth of 2.6% in 2001-05) with that of France, Germany and Italy (average annual growth of 0.9% in the same period). Some have blamed tight monetary and fiscal policy in the euro zone for holding back growth, but such euro-members as Spain, Ireland and Finland have done well.

As it happens, growth in Europe has picked up in recent months, though

a rising euro may slow it down again. The most urgent measures now needed are the further deregulation of labour markets, services, energy and so on. The obstacles to this liberalisation lie largely at national level, although the EU's Lisbon Agenda—the self-imposed measures needed to make Europe "the most dynamic and competitive knowledge-based economy in the world" by 2010—can help to chivvy governments along. So long as the Lisbon Agenda lacks carrots or sticks, it will be up to governments to decide how far to pursue it, and how far to push reform over resistance by unions and other lobbies.

The task of the Brussels commission is to sustain whatever it controls that contributes to Europe's economic growth. This means, above all, safeguarding the single market and its competition rules. A nasty outbreak of economic nationalism struck earlier this year, when several countries started to talk of fostering national energy champions and of protecting their biggest companies from foreign takeover. This must be beaten back. Indeed, much work is needed to bolster all the EU's four freedoms—of goods, services, movement of labour and of capital—each of which has been under attack this year. Once again, the constitution has little directly to do with this. But its demise might be used as an excuse to roll back the single market.



A pause for digestion

Similarly, some politicians are using the constitution's troubles to question the EU's expansion to take in new members. At least some of those who voted no may have done so in protest at the recent and future enlargement of their club. The threat of the mythical Polish plumber played strongly in France. The prospect of Turkey joining was a factor in both France and the Netherlands. Indeed, it was partly because of this that Mr Chirac changed the French constitution to provide that any new entrant after Bulgaria, Romania and Croatia must be approved by a referendum in France. Austria has similarly promised a vote on Turkey, and other countries may yet follow suit.

The expansion of the European club is widely touted as its biggest single success. The lure of membership has helped to entrench stability and democracy, first in the southern Mediterranean and now in central Europe. A similar pull is at work in Turkey and the western Balkans, and even as far afield as Ukraine and the Caucasus. Moreover, the economics of enlargement looks good. An exhaustive commission analysis recently concluded that the entry of new countries from central Europe in 2004 had raised economic growth and created jobs not only in the new members but also in existing ones.

The EU should continue to welcome aspirant countries, for its own benefit as much as for theirs. The alternative is distinctly unappealing. Analysts of the western Balkans agree that, if Brussels were to slam the door, these countries could easily slip back into nationalism, drug- and people-smuggling, organised crime and even war—with lots of undesirable consequences for western Europe. Similarly, a Turkey spurned by Europe could soon regress into a sour and militant Islamist mood, right on Europe's front line.

So the question left by the failed constitution should not be: how can we resurrect it? It should be: what changes are needed to ensure that the EU continues to benefit from its single market, to help promote economic reform and to keep the club open to new members?

Pick and choose

Many different answers have been proffered during the pause for reflection. In some ways, the argument has turned into a new round in the long debate between "institutionalists", who would like a new institutional framework that then produced closer integration; and "incrementalists", who would prefer the club to develop organically, with institutional change coming later.

In this second camp stand, in particular, the British, supported here by Mr Barroso, who thinks further discussion of the EU's institutions should be put off for now. They admit that the current set-up has unsatisfactory features—the six-monthly rotating presidency, a bizarre system of voting, a commission that is too big, a continued muddle over who is in charge of foreign policy. Despite all this, though, the EU is able to function.

Yet it is hardly tenable to suggest that the EU's treaties need no changes at all. Under the Nice treaty, new voting weights and seats in the European Parliament must be fixed for Croatia or any country that joins after it. At that point, too, Nice scraps the rule that gives each country one commissioner in Brussels, though it does not offer a replacement. So some treaty amendment will be needed by 2009 or 2010, when Croatia is likely to join. For that reason a new inter-governmental conference may have to be called to consider treaty changes, perhaps in late

2007, after the French elections.

This gives heart to those who still insist on pursuing the constitution and nothing but the constitution. Even though that looks unrealistic, several governments, including (at least formally) Germany's, stick to it. So does Italy, under Mr Prodi, Luxembourg, Belgium, Spain and some members in central Europe.

A wide variety of ideas lie between the two extremes of no action and the full constitution. Most involve picking the best bits of the constitutional treaty and producing a shorter version, which might even be brought into force without approval by referendum. The trouble with that idea is that few EU members agree on which parts of the document to keep. Typically, big countries want to slim the commission, change the voting system and install a permanent presidency in place of the present six-monthly one. But small countries see most of these changes as steps backward: if they are to accept them, they want something in exchange, such as more majority voting and a stronger European Parliament.

It was the need to balance such widely differing desires that led to such a cumbersome constitutional treaty in the first place. Several leaders have duly given warning against attempts to unpick the compromises that went into the document. Indeed, some countries are no longer willing to honour the concessions they made in the constitution. Poland, for instance, which in 2003 was, with Spain, a fierce opponent of a proposed new “double-majority” voting system, only to give way in the summer of 2004, now says that it wants to stick to the system agreed on in the Nice treaty in 2000.

Besides the practical and political difficulty of resurrecting bits of the treaty, there are two other objections. The first is the democratic one: the people have voted no, which makes it unattractive to bring in any change by the back door, especially if an avowed goal is to avoid consulting the people again. The second is that if, despite that, any new treaty ends up being put to the vote, its odds of passing are small. Around a dozen national referendums have now been held on such EU issues as new treaties and whether to join the euro. As many as six have been lost. In an EU of 25, soon to be 27, in which half the members now choose to put significant constitutional changes to the vote, there is a risk that no treaty will ever be passed.

If cherry-picking does not work, that leaves two other options. One is to put into effect changes that do not require any treaty amendment at all. These could include more openness in the EU's legislative procedures and a bigger role for national parliaments. Such changes could be made at once. The other is to pursue closer European integration within a smaller group. This idea of a hard core that might proceed without the foot-draggers has always appealed to some of the original six. Mr Verhofstadt has proposed basing it on the 12-strong euro group. Mr Chirac has spoken repeatedly of pioneer groups.

The EU is, indeed, turning into a variegated organisation, with clubs such as the members of the euro, a defence grouping, the Schengen passport-free area and the seven-country Prüm group that is pursuing police exchanges and border co-operation. The existing treaties allow “enhanced co-operation” to form such clubs-within-clubs. Yet the notion of a hard core seems unlikely to work. Any such group would have to include France, yet this is now one of the countries most hostile to the European project. As for the euro group, it is destined to expand to take in most central European countries in the next few years. When it has, say, 20 members, it will surely be too big to be a core.

In short, almost any big institutional change is now fraught with difficulty. It is true that some treaty amendments will be necessary when Croatia and, later, others join. Perhaps then, to please the growing band of small countries, a commissioner could after all be retained for each; and the votes in the council might then be reallocated to give a bit more weight to big members. But any such changes will probably have to be kept to a minimum.

If such minor amendments went into the accession treaties rather than a new constitutional treaty, ratification should become easier in most countries. And in one way, such an outcome would be refreshing: it would mean

that, instead of the past decade of endless tinkering with new treaties and constitutions, the European Union would have to concentrate on delivering benefits to its members. Now that's a prospect to reflect on.

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Puerto Rico

Trouble on Welfare Island

May 25th 2006 | AGUADILLA AND SAN JUAN
From The Economist print edition

Everynight Images

Overbearing government and the welfare state are hurting the United States' poorest citizens

AS THE mayor of Aguadilla, on Puerto Rico's north-west coast, Carlos Méndez is proud of his town. He likes to take visitors onto the balcony of the town hall and challenge them to spot a scrap of paper in the plaza. There are none; but here, and all around the centre of town, there are no busy people either. The shops and offices are shabby, with little going on in them. The buildings along the beautiful beachfront look run-down. A few men sit in the shade, and have apparently been planted there as long as the tree has.

Puerto Rico has been a United States territory for more than a century, and its people have been citizens since 1917. They do not vote in national elections or pay federal income taxes, but those are not the biggest differences between Puerto Rican residents and their fellow American citizens. The island is distinguished by its poverty and joblessness, which are far worse than in any of the 50 states. The territory's economy, moreover, has fallen further behind the national one over the past three decades. Bad government—not just locally, but also federally—is largely to blame. Yet most Americans are oblivious to the Caribbean island's problems.

The place did earn a rare and brief mention in some mainland newspapers earlier this month. Its government had hit a borrowing limit and partly shut down for a couple of weeks, putting 95,000 civil servants out of work. Then leaders in San Juan—the commonwealth's capital—agreed on a budget deal that let the government borrow more and resume paying people. The drama ended, and life there reverted to its depressing former state.

Some Puerto Ricans are doing well. Most of Aguadilla's 70,000 people, for example, live in the richer suburbs that surround the city. The area has many of the same fast-food and retail chains that pervade the United States, and companies from the mainland, such as Hewlett-Packard and Micron Technology, have built factories nearby. Much of the island, however, is like Aguadilla's town centre, full of low incomes and idle hands.

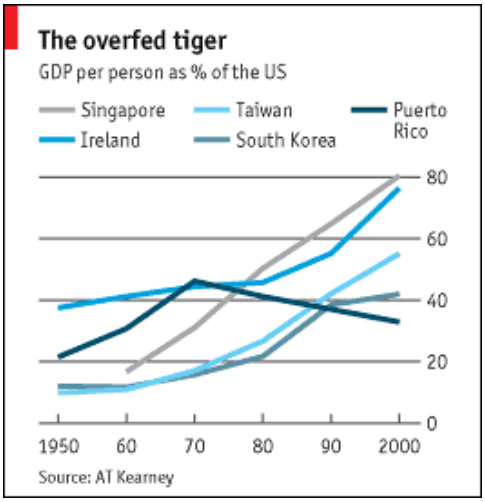
Puerto Rico's annual income per person was around $12,000 in 2004, less than half that of Mississippi, the poorest state. More than 48% of the island's people live below the federally defined poverty line. That poverty rate is nearly four times the national average, and more than twice as high as in poor states such as Kentucky, Louisiana, Mississippi and West Virginia.

Half the working-age men in Puerto Rico do not work. Officially, only 46% of those who are not pursuing a degree have formal jobs, compared with a United States average of 76%. The territory does have a big informal economy. But María Enchautegui at the University of Puerto Rico and Richard Freeman at Harvard University have looked into this, and reckon that counting unofficial workers boosts the employment rate only

to 55%, at best. Their research is included in a new book on the island's problems, put together by two think-tanks: the Brookings Institution in Washington, DC, and the Centre for the New Economy in San Juan.*

Puerto Rico ought to be doing much better, because being part of the United States gives it many advantages over other low-income economies. Most important may be America's legal system, which offers excellent protection, by developing-economy standards, for private property, contracts, patents, free speech and so forth. These guarantees tend to attract outside capital, spur local investment and let commerce and innovation flourish. The island can also trade freely with the giant mainland economy. And its workers can migrate to and from the 50 states at will, gaining skills, creating business connections and making money.

In some ways, generous United States taxpayers have also been useful. To help the territory catch up, they have paid for infrastructure and a huge leap in education levels. The average length of schooling in Puerto Rico rose from 3.7 years in 1950 to 11 years in 2000.



Crutch disease

With these advantages, Puerto Rico grew impressively in the decades after the second world war, even outperforming Asian “tigers” such as South Korea, Taiwan and Singapore (which has roughly Puerto Rico's population). Since the 1970s, however, Puerto Rico has been outpaced badly by the Asian tigers and Ireland, another place to which it is often compared. It has also diverged from the United States, losing ground even to lowly Mississippi.

Many things have gone wrong. Most important, however, is that the United States government assumed too big a role in the Puerto Rican economy, and its largesse enabled the commonwealth's government to do the same. Through hubris, clumsiness and sheer size, these governments knocked Puerto Rico off the promising path that it was following, and the island's economy is now lost in a thicket of bad incentives. Two federal intrusions stand out: an oversized welfare state, and misguided rules on business investment.

Federal transfer payments to Puerto Rico rose sharply in the 1970s. Some programmes have been modified since then, but transfers still make up more than 20% of the island's personal income. These federal handouts reflect the sensibilities of a wealthy country. So by Puerto Rican economic standards, they are huge. And the more a man or woman earns through paid work, the more they decrease.

Puerto Ricans are eligible for federal disability payments, for example, through Social Security. Ms Enchautegui and Mr Freeman point out that, in the territory, federal disability allowances are much higher than the United States average as a share of wages and pension income. Unsurprisingly, therefore, one in six working-age men in Puerto Rico are claiming disability benefits.

Many families do not view the federal handouts as temporary. Neither does Raúl Vega, who owns a consumer-finance outfit in Aguadilla. His firm treats the benefits as income when deciding whether to lend people money for new televisions.

Some Puerto Rican households, of course, would barely struggle along without federal assistance. For many people, however, the money that can be earned through federal transfers and a little informal work is more than the market wage—and requires much less effort. Meanwhile, in a strange echo of America's immigration debate, people from the Dominican Republic do many of the jobs in Puerto Rico that pay too little to attract the locals.

Relaxation without representation

What do Puerto Rico's men do all day? Some get into trouble. But many others hang out in pleasant places that require little money, such as beaches, shopping malls and the armchairs in Borders bookstores. They also watch plenty of television. Downtown Aguadilla may be shabby, but satellite dishes sprout from many rooftops. People always have money for that bill, says Mayor Méndez.

Through tax laws, the federal government has also favoured some business investments in Puerto Rico over others. Most notorious is “Section 936”, a rule that skewed investment towards technologies that were too advanced for Puerto Rico's stage of development. Drug firms and chemical producers built factories that used lots of capital and few workers, because doing so lowered their global tax bills. In a recent book on the territory's economy, James Dietz described this distorted evolution well.†

High technology sounds wonderful. But what Puerto Rico has needed over the past few decades is more medium-tech plants. These would employ more people, teach them skills better suited to the island's level of development, and tighten links to local suppliers and business services. More service jobs for the unskilled would be good, too. Steven Davis at the University of Chicago's business school, another contributor to the Brookings/CNE studies, points out that jobs in tourism and recreation engage a lower share of the workforce in Puerto Rico—despite its beautiful beaches—than in any of the 50 states.

In short, by lowering demand for less educated workers, lopsided investment has exacerbated the welfare-driven distortions in the island's labour supply. The result is lots of idle poor. The Section 936 rules were phased out between the mid-1990s and 2005, but the damage will persist. Many Puerto Ricans have acquired few useful habits and skills over the past three decades; and the welfare state, though smaller than before, is still pervasive enough to lock many of the labour distortions in place.

Puerto Rico's bloated government also bears much of the blame. Around 30% of the territory's jobs are in the public sector. Among other things, a big and coddled bureaucracy undermines Puerto Rico's educational achievements in two ways. First, nearly half those on the education department's payroll are not teachers; quality has fallen because of low accountability and mismanagement. Second, because of the small private sector, too few well-educated Puerto Ricans are gaining useful skills and experience in the marketplace.

As he walked through Aguadilla's town hall recently, Mr Méndez boasted about each employee's university or graduate-school credentials as he introduced them. The trouble, he says, is that “All they want to do is find security only. They have no ambition...Everybody wants to work for the government.” Manuel Reyes, of the Puerto Rico Manufacturers Association, also sees little hope that the government's role will shrink. “There is no light at the end of the tunnel,” he says, “because we are still in denial.” And the rest of America is still indifferent.

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* “The Economy of Puerto Rico: Restoring Growth”, edited by Susan Collins, Barry Bosworth and Miguel Soto-Class. Centre for the New Economy, San Juan, Puerto Rico, and Brookings Institution Press, Washington, DC.

† “Puerto Rico: Negotiating Development and Change”, by James Dietz; Lynn Rienner Publishers, Boulder, Colorado

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The coming threat to gun-owners

UNbelievable

May 25th 2006 | MILWAUKEE AND YEKEPA, LIBERIA
From The Economist print edition

The NRA takes aim at global bureaucrats

Get article background

AFP

New-look Security Council

DUKU PAUL does not know how many people he has killed. Though still young, he is a veteran of one of West Africa's nastiest civil wars. For more than a decade, he helped to burn, loot and bloody his homeland, Liberia. Then, in 2003, the United Nations, with American backing, brought peace. Bangladeshi blue helmets took Mr Paul's gun and gave him $300. Interviewed last year, he said he was sorry that he ever became a soldier, and that he wanted to get back to school.

Mr Paul was enrolled in what the UN calls a “disarmament, demobilisation, rehabilitation and reintegration” programme. The world body is keen to promote such programmes wherever appropriate. The National Rifle Association (NRA), the lobby for American gun-lovers, does not like the sound of that.

“So, after we are disarmed, the UN wants us demobilised and reintegrated. I can hear it now: ‘Step right this way for your reprogramming, sir. Once we confiscate your guns, we can demobilise your aggressive instincts and reintegrate you into civil society.’ No thanks,” shudders Wayne LaPierre, the indefatigable executive vice-president of the NRA.

Why does the UN want to take away Americans' guns? Because it is a club of governments, some of which want to “strip opposition forces of the means to challenge their authority,” argues Mr LaPierre. During the 20th century, governments murdered 169m people in various parts of the world, he says. Individual gun ownership is the “ultimate protection against tyranny”.

Mr LaPierre was signing copies of his new book, “The Global War on Your Guns: Inside the UN Plan to Destroy the Bill of Rights”, at the NRA's annual convention in Milwaukee on May 19th-21st. What do rank-and-file members think? Joe Carlson, a rifle salesman, is serenely unaware of the threat. “I'd not heard about that,” he says. “I've been so busy selling these [award-winning semi-automatic weapons]. I'd better take a look.” Others are better informed. “All these pirate governments want to take from people their rights. That's wrong,” says Greg Johnson, who runs a lodge in Michigan where you can shoot imported Russian wild boars.

For both men, their livelihoods are at stake. Mr Johnson's customers can, it is true, hunt wild boars with “stick and string” (ie, a bow and arrows). But most would prefer to bring their favourite firearm, for those “raging Russian” boars are fierce. “If you hunt him, he'll hunt you,” says Mr Johnson, adding that it is the kind of beast that was running around in the Dark Ages. Yes, “It's one primordial pork chop.”

Mr Carlson's position is even more precarious. The guns he sells are more powerful than the M4 rifles that the army uses. (As any gun-lover knows, with the M4 “there's a problem with one-shot kills,” says Mr Carlson: ie, soldiers are finding it tricky to take out distant targets with a single shot.) Under Bill Clinton, they were labelled “assault rifles” (inaccurately, in Mr Carlson's view) and banned. Congress let the ban lapse in 2004. If “the wrong people” are elected, says Mr Carlson, they'd ban them again in a heartbeat.

The NRA, like so many conservative American groups, has long detested the UN. But Mr LaPierre's claim that it is “the biggest coming threat” to gun-lovers represents a new emphasis. It reflects, in part, his organisation's astonishing success at home. The second amendment is in “the best shape it's been in for decades,” says Mr LaPierre. “Gun-haters” consistently lose elections. The president and both houses of Congress are solidly pro-gun. Last year Congress passed legislation protecting gun manufacturers from “frivolous” lawsuits. Of the 50 states, only two—Wisconsin and Illinois—refuse to let law-abiding citizens carry concealed firearms.

Challenges remain, of course. During the post-hurricane lawlessness in New Orleans last year, the police confiscated a number of legally-held firearms from civilians. Last week, the NRA urged every mayor and police chief in America to pledge never to disarm law-abiding citizens. The governor of Wisconsin, Jim Doyle, has twice

vetoed a law that would have allowed licensed citizens to carry concealed handguns. Gun-owners are urged to “Dump Doyle”, among others, at the mid-term elections in November.

For a truly all-embracing threat, however, the UN is hard to beat. Mr LaPierre predicts that the “global war on guns” will boost the NRA's membership from 4m to 8m, and reduce Hillary Clinton's chances of becoming president in 2008. This last point is crucial. The UN, whatever its evil aims, is hardly in a position to push Uncle Sam around. To disarm Americans, it would need Congress on its side, plus an American president willing to sign an anti-gun treaty and appoint Supreme Court justices willing to rule it constitutional.

Mr LaPierre anticipates that some people might find this far-fetched. “I can hear some readers now: ‘Oh, Wayne's just over-reacting’,” he writes. But that is what they want you to believe. “Just how sure is the United Nations that it can take your guns?” he asks. His answer: “The UN chose the Fourth of July to hold its global gun ban summit on American soil!”

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Congressional scandal

Foiled

May 25th 2006 | WASHINGTON, DC
From The Economist print edition

Cold hard cash, and other obvious puns

WILLIAM JEFFERSON, a Democratic congressman from New Orleans, allegedly likes to keep bundles of cash in his freezer. The FBI does not think this is cool. Last year, according to an affidavit released on May 21st, Mr Jefferson accepted a suitcase containing $100,000 from a businesswoman seeking contracts in Nigeria and Ghana. The FBI says it found $90,000 of this in Mr Jefferson's freezer, stacked in foil-wrapped bundles.

The businesswoman claims that Mr Jefferson, the chairman of the congressional caucus on Nigeria, solicited bribes to help her business. She told the FBI and agreed to wear a wire. Mr Jefferson was recorded complaining about “all these damn notes we're writing to each other…as if the FBI is watching.” Agents raided his congressional office on May 20th. Mr Jefferson has not been indicted, and insists he has done nothing wrong.

Different people find different aspects of this story upsetting. For some in Congress, an FBI raid on a congressman's office is an outrageous breach of the separation of powers between Congress and the executive branch. This is the first time a sitting congressman's office has been raided in that way. John Boehner, the House majority leader, predicted that the case would end up at the Supreme Court.

For others, there is racism afoot, since Mr Jefferson is black. Democrats regret that Mr Jefferson's woes muddy their campaign message that Republicans have a unique “culture of corruption”. For Nigerians, the big shock is that Mr Jefferson allegedly said he needed to pay off Nigerian officials, including one very senior one.

For the people of New Orleans, it has been a mixed week. Their man in Washington may be in trouble, but their mayor, Ray Nagin, was re-elected on May 20th. Mr Nagin is best-known for losing his cool during Hurricane Katrina. He was also accused of race-baiting during his re-election campaign: he said he wanted his town to be a “chocolate city” and remarked to a black audience that “very few” of his primary opponents “look like us”. But a slim majority of voters did not seem to mind. New Orleans is a tolerant place.

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Democrats and global warming

The politics of meltdown

May 25th 2006 | AUSTIN
From The Economist print edition

Could climate change become a hot topic for the primaries?

A RECENT sketch on “Saturday Night Live” suggested how the world would be if Al Gore had won the presidency in 2000. “In the last six years we have been able to stop global warming,” intoned Mr Gore. “No one could have predicted the negative results of this. Glaciers that once were melting are now on the attack.”

Nerdy environmentalism is Mr Gore's forte. He would have ridden that hobby-horse in the 2000 campaign, according to Joe Klein in “Politics Lost”, if his political consultants had not muzzled him. Now, almost alone, he has brought his favourite issue back into the political spotlight. His film about the horrors of global warming, “An Inconvenient Truth”, opened this week in Los Angeles and New York.

With it comes inevitable talk of another try at the presidency. Mr Gore consistently waves that away. But other prominent Democrats are raising their voices for the cause. This week Senator Hillary Clinton urged action on global warming in a big speech on energy policy in Washington, DC. Notably, she praised Mr Gore (now a potential rival for 2008, whatever he says) as a “committed visionary on global warming for more than two decades”. Last week, her husband Bill told graduates at the University of Texas's public-affairs school in Austin—as temperatures outside soared to 34°C—that “Climate change is more remote than terror, but a more profound threat.”

Do voters care? Although a Gallup poll this spring found that 67% of respondents thought the quality of the environment was “getting worse” (a fairly steady rise from 54% in 2002), climate change is hardly in the class of Iraq or health care. And it is still rare for politicians to mention it on the stump. Bill Ritter, the Democratic nominee for governor in Colorado, notes that global warming is a worry for the ski industry in his state—but says his audiences care more about the quality of their water or their air. Most midwestern politicians nowadays cannot talk enough about alternative fuels, but they link them to the economy (and national security) rather than climate change, hoping for a boost for local corn or soyabean farmers.

A few bad hurricanes may change that indifference. The 2006 season begins next week, and federal meteorologists predict it will be particularly nasty. Although conservatives have vigorously disputed the link between global warming and last year's dreadful storms, another Katrina could push people over the edge. Gregg Easterbrook of the Brookings Institution, a think-tank, says that politicians also need a new tack. Instead of dwelling on gloom and doom, they should appeal to American optimism, emphasising that the problem can probably be solved after all, and cheaper and faster than anyone thinks.

And what about conservatives? George Bush has recently conceded that America is “addicted to oil”, but he still argues about the causes of global warming. (“He may be the last person in America who refuses to accept the science on this,” sighs Jay Inslee, a congressman from Washington state.) John McCain, another possible presidential contender in 2008, has been out in front. He has sponsored legislation (with Joe Lieberman, a Democrat) for cap-and-trade emissions of greenhouse gases, and declared in a recent speech in Phoenix that “Climate change is real and is having a major impact on our way of life.”

Other conservatives, however, are mounting attacks on Mr Gore and his film. The Competitive Enterprise Institute (CEI), a Washington advocacy group funded by Exxon Mobil among others, has launched ads with soft music that glamorise carbon dioxide, the key compound linked to global warming. “Carbon dioxide: they call it pollution; we call it life,” runs the slogan. “Why are they trying to scare us?”

These ads have been produced and aired on a $50,000 budget and have been shown in smallish markets, but they are on CEI's website, and are thus creating a buzz. The debate may well stay hot through the 2008 primaries. But past experience suggests that the general election will be won or lost on other, more serious issues: such as single mothers, the spelling of “potato”, and looking silly in tanks.

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Chesapeake Bay crabs

A glut of claws

May 25th 2006 | RICHMOND
From The Economist print edition

And nobody but Mexicans to pick 'em

AFP

Scramble, guys! It's a chef!

AS WARM weather returns to Chesapeake Bay, so too does one of its delicacies: blue crabs. Seasoned and steamed, breaded and lightly fried, or picked clean for crab cakes, few crustaceans are more delicious. As recently as the mid-1970s, the Chesapeake yielded approximately half America's blue-crab harvest. Even bad years were impressive, generating 50m to 80m clawed and twitching pounds from what H.L. Mencken once called an "immense protein factory". But this year's harvest of the bad-tempered creatures from the waters of the bay has been more vexed than usual.

The first crab catch this year was the biggest in more than a decade. Yet the glut, attributed to the mild winter and an increase in the number of juvenile crabs, is bringing anything but profits for the watermen, some of whom still speak with the Elizabethan lilt of their 17th- and 18th-century British ancestors. Prices at the dock are running at $8-10 a bushel (60-80 crabs), down from $30 in April. Last year, the price ranged from $40 to $85. Male crabs, or "jimmies", bring the best prices.

Globalisation has exacerbated the problem along Chesapeake Bay and in the coastal Carolinas, another important regional crab ground. The American market has been flooded with imported crab, most of it from Asia. In 2000, an effort was made to restrict foreign competition the old-fashioned way. The Blue Crab Coalition, made up of firms from Virginia, Maryland and North and South Carolina, asked America's International Trade Commission to impose tariffs on imported crab, but was turned down.

Now the floodgates have opened. Last year 46m pounds of blue swimming crab, a species similar to the Atlantic variety, were shipped to America: twice the amount imported in 2000. The top three sources were Indonesia, Thailand and China. In contrast, crabbers in Maryland produced just over 2m pounds in 2005.

Cheap imports are the latest threat to an industry already weakened by unchecked growth and neglect of the environment (industrial waste and farm run-off both choke most aquatic life in the bay). All this has combined to shut down crab-picking houses. Maryland now has 27 houses, compared with 49 nine years ago. In Virginia, only a few can handle the current surplus. The state's biggest, in Hampton, even stopped buying crabs because the firm needed more pickers—and had to get them from Mexico, since this is a job few locals want.

Meanwhile, Virginia watermen, with no one to sell to and, in some cases, already earning half their daily take, are staying ashore because they cannot absorb the rising cost of fuel for their boats. The situation, noted the Richmond *Times-Dispatch*, "is squeezing watermen right out of their white vinyl work boots."

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Poverty ratings

The not-so-Golden State

May 25th 2006 | LOS ANGELES
From The Economist print edition

An unexpected candidate for sympathy

PLENTY of California's 36m residents are living the American dream—the “McMansion” in a gated community, the children at private school, even, for some, the yacht moored in Marina del Rey. But plenty more will never get near the dream. According to a new report by the non-partisan Public Policy Institute of California (PPIC), America's most populous state is now the third-poorest in the nation, behind Washington, DC, and New York, with almost 6m Californians living below the poverty line.

The underlying explanation, says the PPIC, is California's high cost of housing. According to federal statistics, California is only the 15th-poorest state in the nation—but the PPIC points out that the federal definition of poverty dates from the 1960s and ignores house prices. Instead, the federal definition simply multiplies the cost of food by three on the assumption that families spend a third of their budget on food. For a family of four that meant income in 2004 of $19,157, appreciably lower than the 12-month rent for a modest two-bedroom apartment in San Francisco of $21, 300.

In an effort to be more realistic, the PPIC has adjusted the federal threshold by assuming that poor families spend an average of 44% of their budget on housing. That means lowering the national poverty figure from 12.7% to 12%, but raising California's figure from 13.3% to 16.1%. In San Francisco the federal poverty rate in 2004 was 10%, but the adjusted rate 19%; in Los Angeles County the federal figure was 16% and the adjusted figure 20%. Only in the sprawling “Inland Empire”, east of Los Angeles, and in the Central Valley, were federal rates higher than the PPIC's figures.

So do the rich get richer and the poor get poorer? With unskilled immigrants pouring in from Latin America (28% of Californians in 2004 were immigrants, compared with 10% in 1969), the gap between rich and poor is growing faster in California than anywhere else in America. A family at the 10th percentile of income in 2004 had an income of $15,600, a fall in real terms of 12% since 1969. At the same time the percentage of poor families with a member working full-time has actually risen, from only 12% in 1969 to over 30% in 2004.

Behind all these measures is a mix of social ills: maids, for example, who must commute for hours from gritty parts of the San Fernando Valley to scrub the floors in plush west Los Angeles; or Latino children who drop out of school and join gangs. But there is a policy defect, too. Since the government uses federal poverty thresholds to determine who has a right to federal assistance, measuring poverty realistically clearly matters. As it is, California's poor have a right to feel short-changed.

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Lexington

American theocracy

May 25th 2006
From The Economist print edition

Is God ambidextrous?

YOU cannot get more brazen than holding a political rally in a church. Last week, more than 1,000 religious activists gathered in a splendid old one in Washington, DC, to talk politics. They discussed their spiritual agenda for America, swapped stories about power struggles within their party and travelled to Capitol Hill to lobby congressmen.

But this was not another example of the religious right on the march. A striking number of the men looked as if they were taking part in a beard-growing competition. Many of the women were in shocking pink. The speakers included a wilderness guide-cum-meditation teacher and a shaman who specialises in helping activists to “access spiritual wisdom”. One speaker worked the crowd into a frenzy with rhetorical questions (Does God believe in invading Iraq? Does God believe in cutting taxes for the rich?) before urging them to “hug your neighbour” and “show some love”. The Southern Baptist Convention this was not.

The religious left is more energised than it has been for years. The number of new-wave “values voters”—who loathe, rather than love, the values embraced by George Bush—is growing rapidly. They range from blacks and Latinos (who are among the most churchgoing people in the country) to left-wing evangelicals to a hotch-potch of Buddhists and gurus, and they are coming together to make their voices heard. The religious left has acquired spokesmen in the form of Jim Wallis, the author of “God's Politics”, and Michael Lerner, a rabbi and the organiser of last week's conference. Several topical themes are giving it momentum, from immigration reform, where the Catholic church has been particularly outspoken, to Iraq.

Hence the reappearance of one of those questions that has been bugging Democratic strategists for decades. Can the religious left become a force in American politics comparable to the right-wing version? Religious leftists point out that a growing number of people are disillusioned with the choice between a pious right, which thinks that Jesus cared more about gay marriage than poverty, and a secular left that believes religion has no role in the public square. They also argue that the religious left has a proud history in America, from the Social Gospel wing of the Progressive movement to civil-rights campaigning. The political marriage between religion and the right, they argue, is the exception rather than the rule.

The Democratic high command has at last worked out that it does not have much chance of thriving in one of the most religious countries in the world if it cannot close the “God-gap”. Yet, if anything, the God-gap is growing. In 2004 Mr Bush won 64% of the votes of people who go to church more than once a week and 58% of people who go once a week. The proportion of people who regard the Democratic Party as less “friendly” towards religion than the Republican increased from 12% in 2003 to 20% in 2005. Fully 67% of people think that liberals have gone too far in keeping religion out of schools.

The growing God-gap has set off a flurry of activity in Democratic circles. Two of the most left-wing members of the leadership—Nancy Pelosi and Howard Dean—have courted “values voters”, Ms Pelosi by visiting Lakewood mega-church in Houston and Mr Dean by appearing on Pat Robertson's “700 Club”. The Democrats have fielded a pro-life candidate, Bob Casey, to take on Rick Santorum in the Pennsylvania Senate race. Both Hillary Clinton and Edward Kennedy have gone out of their way to argue that abortion is a tragedy as well as a right. Messrs Wallis and Lerner have become familiar figures on Capitol Hill.

But is this truly a sea-change in American religious politics? Or is it a brief “hallelujah moment”—born of Bush fatigue and political opportunism—that will bring no lasting change? The betting is on the latter. The religious left suffers from two long-term problems. The first is that it is building its house on sand. The groups that make up the heart of the religious left—mainline Protestants, liberal Catholics and reform Jews—are all experiencing long-term decline. Most of the growth in American religion is occurring among conservative churches. And the constituent parts of the religious left are also at odds over important issues. Middle-of-the-road Catholics are happy to march hand-in-hand with mainline Protestants over immigration and inequality. But they often disagree over abortion and gay rights.

The secular left usually wins

Serious doubts also persist about how much the Democratic Party is willing to change to embrace religion. Some influential Democrats want real change. Others think that all they need to do is drop a few platitudes to religious voters and the God-gap will disappear. Mr Dean's performance on Pat Robertson's television programme was as telling as it was laughable. He not only chose to talk to a man who plays a much bigger role in the liberal imagination than among evangelicals; he also let slip that Democrats “have an enormous amount in common with the Christian community.”

The biggest problem for the religious left is that it is badly outgunned by the secular left. The Democratic Party's elites—from interest-groups to funders to activists—are determinedly secular. So are many of its most loyal voters. John Kerry won 62% of the vote of people who never go to church; and that group is the fastest-growing single “religious” group in the country. These secular voters don't just feel indifferent to religion. They are positively hostile to it, regarding it as a embodiment of irrationality and a threat to liberal values such as the right to choose. These crusading secularists are in a particularly militant mood at the moment, as the sales of Kevin Phillips's Bush-bashing book, “American Theocracy”, testify. The last thing they want is a religious left to counterbalance the religious right.

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Correction: the Mississippi Delta

May 25th 2006
From The Economist print edition

Our piece on the Mississippi Delta claimed that the infant mortality rate in the United States was 7%, and in the Delta 10%. This should of course have been 0.7% and 1%. Figures for the Delta, though bad, are not at the level of sub-Saharan Africa. Our apologies.

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Colombia

Uribe prepares for an encore

May 25th 2006 | BOGOTÁ
From The Economist print edition

Reuters

A remarkable, if controversial, president seeks a second term

HE CAME to power four years ago when Colombia was riven by armed conflict and its economy was barely out of its first recession in seven decades. In the eyes of most Colombians, Álvaro Uribe has since transformed their country. Life in the main cities is more secure, and it is now possible to drive between them with little likelihood of being kidnapped. The economy has grown at an annual average rate of 4.7%, rising to 5.0% last year. Of the three illegal armies responsible for most of the violence, the right-wing paramilitaries have demobilised, and the guerrillas of the ELN talk of doing the same. The FARC, the larger guerrilla group, is still in arms, but has called on its (few) civilian supporters to vote rather than repeating its normal electoral boycott.

So it is no surprise that Mr Uribe, an intense workaholic, seems likely to win a second term in a presidential election on May 28th. The latest polls gave him almost 60% of the vote, enough for outright victory. His nearest challenger, Carlos Gaviria, from the Democratic Pole, a newish left-wing party, trails with 20%. But Mr Uribe's support has slipped in recent weeks—partly from sheer political gravity, and partly because of stumbles such as a scandal involving the secret police.

The bigger question is whether Mr Uribe could use a second term, assuming he gets one, to consolidate the achievements of the first. The shakiest part of his record is “the war on drugs”. This was the centrepiece of Plan Colombia, under which the United States has pumped in some $4.5 billion of aid since 2000. Mr Uribe enthusiastically backed the large-scale spraying of coca fields with weedkiller. But the United States' drug warriors recently concluded that the total area under coca has barely dropped since 2002.

The government is now putting more stress on manual eradication. But the eradication squads face attacks from FARC, which gets much of its income from drugs. Worse, on May 22nd an army patrol killed ten police from an elite drugs squad in what was said to be an accident. Many former paramilitaries remain involved in the drug business.

Improvements in security are more tangible, though they will remain fragile as long as drug money flows. Murders and kidnaps are at their lowest for two decades, according to official figures. Mr Gaviria questions the numbers—he says that Mr Uribe has “created a virtual country”—though he offers no evidence to back this claim up. Away from the cities, violence continues to make large areas unsafe.

In a ruling this month, the Constitutional Court upheld a controversial law that set the terms of the demobilisation of the right-wing paramilitaries (and, Mr Uribe hopes, of the left-wing guerrillas in future). But the court gave the law more teeth, which may prompt some paramilitaries to rebel. Recent revelations of links between the secret police and the paramilitaries point to the need for a clean-up.

Some see FARC's decision not to call for an election boycott as a sign of weakness. Francisco Santos, Mr Uribe's vice-president, cautions that the guerrillas are merely biding their time. Alfredo Rangel, a security analyst, forecasts an upturn in guerrilla violence after the vote.

Mr Uribe is the first to acknowledge that his job is far from over—the reason he successfully sought a constitutional change to allow re-election. But a second term would be no easier than the first.

As a former Liberal who stood as an independent and has since won the support of the Conservative Party, the president has contributed to the fragmentation of Colombia's two-party system. His allies gained a majority in both houses of Congress in an election in March. But they are divided between several parties.

In a second term, Mr Uribe would seek reforms aimed at strengthening the economy and the political system. According to Mr Santos, these include measures to simplify the tax code, to offer better treatment to foreign investors and to ratify a proposed free-trade agreement with the United States. A proposed constitutional reform would try to crack down on corruption in local government by imposing tighter central controls on spending. It would also scrap an increase in transfers to local governments mandated for 2009. That is important to free up money for further expansion of the security forces—essential if FARC is ever to be persuaded to negotiate.

Mr Santos rules out reforming the state-pension system. This accounts for a third of social spending, and 70% of pensions go to the richest 20% of the population, according to Mauricio Cárdenas of Fedesarrollo, a Bogotá think-tank. Mr Uribe has promised to double the size of Families in Action, a well designed cash-transfer programme aimed at poorer Colombians, from 500,000 families to 1m.

In his first term, Mr Uribe benefited from luck as well his own boldness and hard work. Colombia's economy was boosted by high prices for exports of oil, coal and nickel. It helped, too, that the economies of its main trading partners, the United States and Venezuela, were growing strongly. The next administration may not be able to rely on such good fortune. According to Sergio Clavijo of ANIF, another think-tank, Colombia risks becoming a net importer of oil by 2010.

It is a backhanded tribute to Mr Uribe's success that polls show that Colombians now worry more about the economy than about security. But that also points to a changed agenda for the next four years. “It's a mistake to think that the conflict must first be resolved for the economy to grow,” says Mr Cardénas. “We need economic growth in order to resolve the conflict.” Even in the best of circumstances, second terms are often a disappointment. Mr Uribe will be an especially hard act to follow—even if, as seems likely, it is by himself.

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Chile

Coping with the copper boom

May 25th 2006 | SANTIAGO
From The Economist print edition

Corbis

Storing the windfall abroad, to keep the heart of the peso

Get article background

ECONOMIC windfalls can be bittersweet. They tempt governments to splurge with money that may disappear tomorrow. They drive currencies higher, hurting producers of everything but the hot commodity. Those are the problems facing Chile.

The price of copper, its main export, has quadrupled in three years and all but doubled in the past five months. Despite recent wobbles in the price, the Central Bank predicts that the trade surplus will reach $17 billion, two-thirds higher than last year's record. The peso has appreciated from 750 to the dollar in early 2003 to 511 last month, before falling slightly.

“At today's exchange rate, you have to be very good to achieve positive cash flow, let alone a return on investment,” says Jonathan Bass of Dole Chile, the country's biggest fruit exporter. Dole has shut one of its apple-packing plants. Concha y Toro, the largest wine exporter, is cutting investment. So are producers of olive oil, one of Chile's fastest-growing agribusinesses. The economy grew by 5.1% in the first quarter compared with the same period last year, a bit less than expected. That was mainly because farm output fell by 2.4%.

So is the copper boom a curse rather than a blessing for Chile? There are two reasons to think not. One is that the economy remains strong despite the symptoms of “Dutch disease” (the damage to competitiveness from a commodity export boom). The second is that the government proposes to save much of the windfall, giving relief to the currency.

The finance minister, Andrés Velasco, expects investment to reach a record 30% of GDP this year. He says that employment is growing fast and there is no evidence yet of a fall in agricultural jobs. Economic growth is expected to slow a little, but to a still-healthy 5.5% this year. That is above the government's forecast of long-term potential growth. “There's no question that a [stronger peso] reduces profitability,” admits Mr Velasco. But in real terms, measured against a basket of other currencies, the peso is barely above its average of the past ten years.

Still, the government is worried enough to handle the copper windfall with care. Addressing the Congress on May 21st, Michelle Bachelet, Chile's new president, vowed to keep the strict fiscal rules that have been in place since 2000. These hold public spending to a level that would produce a budget surplus of 1% of GDP if copper were at its long-term forecast price and the economy were growing at its potential (both benchmarks are determined by independent experts). In the first quarter, the actual budget surplus was 2.2% of annualised GDP.

The government is defining more clearly how it will use the surplus. Much of the money will now be kept offshore in foreign currency, taking the heat off the peso. Under this plan, the government will give 0.5% of GDP a year to the Central Bank, which was lumbered with debt in a bank bail-out in 1982-83. A further 0.5% will now go to an offshore kitty, on which the government can draw in ten years' time to meet its obligation to provide a basic minimum pension. Any surplus beyond 1% of GDP will go into a new “economic and social stabilisation fund”, also to be held abroad. In lean times, the government will draw on this, rather than contract debt. This would strengthen Chile's counter-cyclical fiscal policy, as well as helping to restrain the peso's rise, says Mr Velasco.

Ms Bachelet declared that Chile should be exporting “not only copper but mining software, not only fruit but techniques for packing and preserving food, not only salmon but vaccines against fish diseases.” That hope depends on technology and education, rather than the exchange rate. She pledged to raise spending on research and development from 0.6% of GDP to 1% by the end of her four-year term. She wants to improve the quality of education, in part by increasing subsidies for good schools. Her predecessor, Ricardo Lagos, made similar promises and broke them. Ms Bachelet will need to spend shrewdly as well as saving wisely.

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Canada's immigration debate

Help wanted

May 25th 2006 | OTTAWA
From The Economist print edition

Please come and help us grow rich

WITH its economy riding the global commodities boom and unemployment at its lowest rate for 30 years, Canada faces a problem many other countries might envy: it has run out of workers, or at least of many kinds of blue-collar workers. In Alberta's oil sands, and in neighbouring British Columbia, which is preparing for the 2010 Winter Olympics, there is a backlog of construction projects worth billions of dollars. Across the country, builders are competing fiercely for anyone who can wield a hammer, trowel or welding torch.

This labour shortage has sparked a debate about immigration that is different from the one convulsing the United States. In Canada, the main issue is not illegal immigrants. It is about how to change the country's large, legal immigration programmes so that they reflect Canada's new economic and demographic needs.

One underlying problem is that fewer Canadians are joining the labour force. This shrank last year, for the first time ever when the economy was not in recession. Young people are staying longer in higher education. In oil-rich Alberta, fewer women are looking for work. It is not clear whether that is because of their husbands' hefty paycheques or because Alberta's social conservatism is confining them to the kitchen. Another problem is that although the overall unemployment rate is still 6.4% it is almost half that in the booming west.

Desperate employers are scouring the country—and beyond—for workers. On the Atlantic coast, where jobs disappeared along with cod and coal mines, some villages have now emptied of men. They have gone to work in the oil sands 4,000 kilometres (2,500 miles) away. To take them there, Air Canada has added new routes. In northern Saskatchewan, a highway is being asphalted to speed the province's last big pool of unemployed labour to Alberta. Last winter, employers' groups from Alberta and British Columbia held job fairs in Europe.

That points to weaknesses in the government's long-established immigration programme. This is biased towards postgraduates and potential investors, and against skilled labourers. And it grinds slowly: around 260,000 people are accepted each year, but there is a backlog of 800,000 applications. Some migrants, such as doctors and nurses, find that their professional qualifications are not recognised. Toronto is said to be full of taxi-driving doctors and nuclear physicists.

Canada also admits about 95,000 foreigners a year as temporary workers. Some employers now want to expand this programme, not least because permits are granted quickly. Applications can be processed in as little as a week, whereas some applicants for permanent residence have languished on the waiting list for up to 17 years. Almost half of the temporary workers go to Ontario. Now the west wants a bigger share.

The critics of this guest-worker scheme, including trade unions, argue that it depresses wages and undermines working conditions. They are outraged that Canadian Natural Resources, an oil and gas firm, hired a Chinese contractor not just to build an oil-sands project but also to supply some of the workers. Strip-club owners used the programme to bring “exotic dancers” from eastern Europe. When some were forced into prostitution, human-rights groups complained that the scheme was being abused for people-trafficking. Like the United States and Britain, Canada has not signed a UN Convention that protects the rights of migrant workers.

In its first budget last month, the new Conservative government cut residence fees for new immigrants, and promised more money to help newcomers find homes and jobs. Monte Solberg, the immigration minister, accepts that the scheme for temporary workers has some problems, but wants to expand it.

Importing guest-workers to a country that has long prided itself on absorbing immigrants does not look like the best solution to Canada's skills shortages. Better would be to tweak generous benefits to coax the jobless back to work—even if that means moving provinces—as well as fixing the immigration rules.

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Argentina

Gringo invasion

May 25th 2006 | BUENOS AIRES
From The Economist print edition

Looking for lofts in Buenos Aires

IN 2003, when John Kahoun, a New Yorker, decided to buy an apartment as a rental investment, he was deterred by the cost of property in Manhattan. So for $70,000 he bought a loft in Buenos Aires, the home of his former wife. As Argentina's economy has recovered from its 2001-02 collapse, so have property prices. Mr Kahoun's property in Palermo Viejo, a trendy neighbourhood beloved by film-makers and artists, has nearly doubled in value.

Foreigners like Mr Kahoun have contributed to a continuing property boom in Buenos Aires. They account for up to a quarter of buyers in some wealthier neighbourhoods. Two years ago, Michael Koh, an American, set up Apartments BA, a firm which buys property for foreign clients and rents it out to foreign tenants—about 15% of whom come to the city for plastic surgery. Mr Koh says his investors, many of whom have never seen their properties, enjoyed a rise in their capital asset of 25% last year on top of rental income worth 10% of their investment.

By comparison with the United States or Europe, housing in Buenos Aires is still cheap. Modern apartments in the elegant districts of Palermo and Recoleta cost less than $1,500 per square metre, and bargain-hunters can buy in slightly older buildings in pleasant, middle-class *barrios* for a third less.

So far the foreign invasion has not prompted a xenophobic backlash. That may be because it is largely confined to the leafiest neighbourhoods, where many new blocks of flats are going up. And foreign buyers must climb over mounds of red tape.

Sellers demand cash. But foreigners are not legally allowed to bring large sums of money into the country. So the typical route is to transfer the money to the account of an Argentine foreign-exchange house held at a bank abroad. The exchange house converts the funds into pesos, to comply with controls on the import of foreign currency, and then back into dollars (for a fee of around 2%). On completion, the exchange house presents the buyer with a suitcase full of cash to hand over to the vendor. Only then can the would-be resident of Buenos Aires celebrate with a steak and a bottle of *vino tinto*.

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Indonesia

Progress, with a backdrop of volcanoes

May 25th 2006 | JAKARTA
From The Economist print edition

The world's biggest Muslim country is making steady, if slow, economic and social progress. But it remains vulnerable to threats, from terrorism to tsunamis

Get article background

MERAPI, on the densely populated Indonesian island of Java, is one of the world's most active volcanoes. For several weeks it has been puffing out dense ash clouds and spitting the occasional gob of red-hot lava. Its last full-scale eruption, in 1994, killed dozens. One in 1930 incinerated more than 1,000. Javans, being rather superstitious, may see Merapi's rumblings as an ill omen. Even to the non-superstitious, the volcano's threatening signs serve as a metaphor for Indonesia's continuing vulnerability even at a time when the country is generally doing well.

Though the rupiah's recent sharp ups and downs might suggest otherwise, the public finances are no longer a main source of risk. Better financial management since the downfall of the corrupt Suharto regime in 1998 has halved the government's debt ratio to under 50% of GDP. The International Monetary Fund noted in a glowing report on May 19th that President Susilo Bambang Yudhoyono's competent economics team looks set to cut it to 30% by 2009. The same day as the fund's vote of confidence, Indonesia received another boost in the form of an upgrading of its credit ratings by Moody's.

Although Mr Yudhoyono often appears indecisive, he has one bold move to his credit. Last October he slashed state subsidies on fuels, more than doubling their prices. As a big producer of oil and gas, Indonesia has been earning extra revenues from high world prices. But the subsidies were straining the public purse. Since the rich also benefited from them, they were wasteful. Cutting them may have dampened growth and raised prices, but the IMF reckons recovery is on the way, with the economy expected to grow by 5.2% this year and inflation hitting the bottom of its target range of 7-9%.

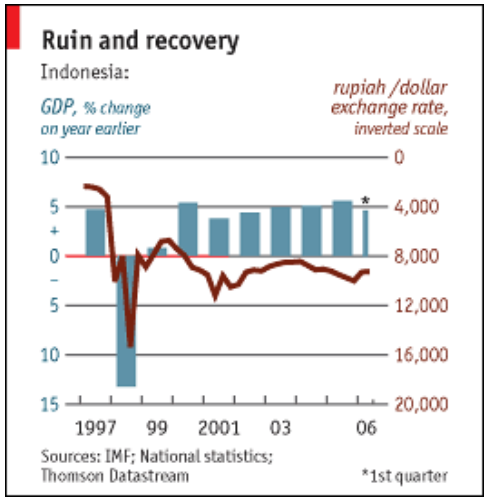
However, in the same week as the IMF and Moody's praised him, Mr Yudhoyono received a downgrade from his voters. Polls from the Indonesian Survey Circle reported that the president's satisfaction ratings had hit a low of 38%, half what they were when he took office in 2004. The main reasons are the fuel-price rises and Mr Yudhoyono's proposed reform of Indonesia's restrictive and job-killing labour laws. There have been protests against his changes, which some workers see as an attack on their rights. However, there is little danger of Mr Yudhoyono having to restore the subsidies. On the labour law, he has stalled, creating a group of experts to set out the case for creating jobs by cutting the burdens on employers.

Mr Yudhoyono contained the backlash against the fuel-subsidy cuts by demonstrating how the $8 billion-plus of annual savings can be spent alleviating poverty. In the months leading to the cuts, the government rapidly set up

a national programme of welfare payments, worth 300,000 rupiah ($32) each quarter, for around 16m poor households, covering over a quarter of the population.

In terms of the numbers of poor people it reaches, the new scheme is the biggest of its kind in the world, says Bill Wallace, a World Bank economist in Jakarta. Yet it seems perfectly affordable, costing around a quarter of the money saved from cutting subsidies. It is designed to last only a year. But the government is now looking at replacing it with a more comprehensive, long-term anti-poverty scheme, perhaps copying Mexico and Brazil by introducing monthly cash payments for poor families on condition that their children attend school regularly.

Like the two Latin American giants, Indonesia needs big structural reforms to free its labour market, encourage private investment and redirect government spending. But such changes are often painful in the short term and are opposed by powerful interests. Though Indonesia has made progress with the fuel-subsidy cuts, many other reforms—most notably privatisation—remain stuck.



Mr Yudhoyono has made progress in areas other than the economy. A peace deal with separatists in Aceh seems to be holding; and more Islamist terror suspects are being brought to justice. Mr Yudhoyono is pushing ahead with tackling the endemic corruption in public life, at least so long as those involved are not too powerful. The head of PLN, a state electricity giant, was arrested this month and the heads of the graft-ridden customs and tax agencies have recently been fired. One regional governor was jailed for corruption last year; another has recently been questioned by the police.

Mr Yudhoyono does not have to face the voters again until 2009, so he has time for his reforms to show results and, he hopes, to restore his popularity. But that assumes that no other event comes along to blow the country off course.

There are several such possibilities. One might be an explosion of discontent fuelled by high unemployment in towns and cities. Another could be bigger clashes between secularists and Islamists. Secular Indonesians see a sweeping anti-pornography bill, being pushed by Islamists in the parliament, as an attack on women's rights and freedom of speech. They are also angered by the efforts of various conservative provincial governments to introduce elements of *sharia* law.

Meanwhile, the sprawling Indonesian archipelago remains vulnerable to all sorts of natural disasters, from volcanoes, earthquakes and tsunamis to outbreaks of deadly diseases. The World Health Organisation said this week that a new spate of human deaths from bird flu in Sumatra was “the most significant development so far in terms of public health”, raising the spectre of a human pandemic. The faster Mr Yudhoyono presses on with making Indonesia better governed, the more capable it will be of recovering from disasters, be they natural or man-made.

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Education and caste in India

We have a few reservations

May 25th 2006 | DELHI
From The Economist print edition

A quarrel less about educational opportunity than political opportunism

Reuters

Upper-caste protest

FOR all the glories of its ancient civilisation, India has “a despicable history of inequity”. So says Pratap Bhanu Mehta, a leading political scientist and, until this week, a member of the National Knowledge Commission, appointed by India's prime minister, Manmohan Singh, to advise his government. The phrase featured in Mr Mehta's eloquent letter of resignation, protesting at the government's determination to “reserve” 27% of the places in its colleges for the Other Backward Classes (OBCs)—lower castes, but not the very lowest, who already benefit. This policy, complained Mr Mehta in the letter, would ensure that India remained “entrapped in the caste paradigm.”

Mr Mehta and a colleague quit after a month of protests against the proposals. Some students are fasting; striking doctors have closed hospitals; demonstrations have turned ugly, as stick-wielding police have beaten up protesters. Nevertheless, on May 23rd the Congress party's ruling coalition announced that the reform would be implemented next year. Until then, the idea had been “nothing but a burning matchstick”, said Anirudh Lochan of Youth for Equality, one of the groups leading the protests. Now, he predicted, “the whole country will burn.”

The issue of reservations is indeed one of the most incendiary in Indian politics. In 1950 India's constitution provided quotas in education and government jobs for tribal peoples, and for “scheduled castes”—the *dalits*, formerly known as untouchables, at the bottom of the thousands of hereditary castes making up Hindu society. In 1990 the government approved a long-neglected report by the Mandal commission, recommending the extension of reservations to the OBCs, but excluded education from the new quotas. Even so, the effects were profound: nationwide protests, and the growth of the caste-based parties that now dominate politics in some of India's biggest states.

Supporters of quotas argue that they have been successful in the southern states, where they have been used extensively. In Tamil Nadu, 69% of college places are reserved. But Mr Mehta argues that, in the north at least, the deprivations faced by the tribes and *dalits* are different from those suffered by the OBCs. For the latter, quotas are “condescending palliatives”.

In an unavailing effort to placate critics, the government has said that it will increase the total number of places in colleges, to ensure that no qualified student is worse off. Arithmetic dictates a 54% increase. No one knows where the necessary teachers, buildings and support services would come from.

A curious feature of the debate is the ignorance on which it is based. The Mandal commission assumed that OBCs made up 52% of the population. Yet a 1999 survey by the government's statistical organisation put the proportion at 32%, or 36% if Muslim OBCs were included. Of those enrolled in college, 23.5% were OBCs. So the under-representation of this group is not extreme. A television interviewer put these findings to Arjun Singh, the minister for human-resource development, architect of the latest reform. He could only waffle that “the OBCs form a fairly sizeable percentage of our population.”

Nor did he contradict research carried out by the elite Indian Institutes of Technology. This shows that one-half of the places they have reserved for *dalits* and tribal people are vacant. In those that are filled, one in four students do not complete their degrees. This indicates that the fundamental failure of Indian education is not discrimination in tertiary institutions; rather, it is the inability of primary and secondary schools to produce enough qualified students. Meanwhile, a shortage of well-qualified college graduates has become one of the biggest threats to the continued rapid growth of India's services and other industries, and hence to the booming economy.

The government's determination to extend reservations can be blamed on politics. Some close to the prime minister scent an effort by Arjun Singh to embarrass his boss, whose job he is widely reckoned to think should be his. Others see it as a concerted bid by the Congress party to win votes in India's caste-ridden largest state, Uttar Pradesh, where elections are due next year. Either way, the benefits for those justifiably angry at the deprivation

and discrimination they suffer in India are likely to be marginal. Mr Mehta quoted Tom Paine: “We pity the plumage, but forget the dying bird.”

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The Three Gorges dam

A terrible beauty is born

May 25th 2006 | MAOPING
From The Economist print edition

China's mighty dam nears completion

THE Three Gorges Dam on the Yangtze River is not quite what it is often made out to be. It is often called the world's biggest hydroelectric dam. But several others are taller or longer. The Itaipu dam on the Brazil-Paraguay border produces more electricity, at least for now, and claims it will continue to do so even though China's dam will eventually have more capacity.

No one, though, can doubt China's determination in getting the thing built. On May 20th a topping-out ceremony was held at the 2.3km (1.4 miles) long, 181-metre high structure after 13 years of work—and a few months ahead of schedule. Chinese newspapers hailed the fulfilment of a national dream whose origins go back to the revolutionary leader, Sun Yat-sen, early in the 20th century. With unusual candour, the official media said the task had cost the lives of more than 100 workers.

But neither the construction nor the huge controversy it has generated is over yet. On June 6th another milestone will be reached when a 580-metre temporary coffer-dam protecting the just-completed final stretch of the main dam will be blown up. Installation of the 12 remaining generators, in addition to the 14 already operational, is due to be completed in 2008, a year ahead of schedule. And much work remains to be done on a complex machine for raising boats over the dam. It will be the world's largest ship lift, but it has been plagued by delays and may not be finished before 2010.

The dam is certainly a record beater for the numbers of people it has displaced. Officials say 1.13m have been moved from towns and villages upriver to make way for a reservoir that will stretch for 660km. Another 172,000 have yet to be uprooted. These figures are conservative. Many people living upriver from the dam without long-term residence permits have not been counted or compensated. Many others complain that corrupt officials have siphoned off resettlement funds. Numerous protest leaders have been arrested or jailed over the years.

Officials say the dam's colossal energy output will help reduce the country's dependency on coal by some 50m tonnes a year. But damage to the environment will be considerable too. Nearby residents say water quality upriver has visibly worsened. The government says it spends more than $1.3m a year collecting rubbish from the reservoir. But clusters of detritus are common in the once fast-flowing water.

A project official said last week that the dam would cost about 10% less than its budget of $25.2 billion, though it is widely believed that the true cost has been much higher. China has not been deterred by all the criticism. More large dams have been proposed for the Yangtze's upper reaches and on the parallel Nu River. There has been outspoken opposition from Chinese environmentalists, to limited avail. Work on one new dam at Xiluodu on the upper Yangtze, which will rival Itaipu's power capacity, resumed last year after being halted for a few months for an environmental assessment.

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The Koreans

Labour problems

May 25th 2006 | KAESONG
From The Economist print edition

An industrial park causes tensions with America

AMERICA'S chief negotiator on North Korea, Christopher Hill, visited Seoul on May 25th, part of an effort to re-start stalled talks over North Korea's illicit nuclear programmes. Increasingly, though, America and its ally South Korea are at odds about the North. America tends to see the South as far too soft on its neighbour, a view well illustrated by the two countries' attitude towards a quite separate North-South issue: Kaesong, an inter-Korean economic project just across the border in the North.

In a series of recent commentaries and speeches, America's special envoy for human rights in North Korea, Jay Lefkowitz, has raised concerns about the exploitation of workers at Kaesong, where southern investment and know-how is united with cheap northern labour. A furious South Korean government has accused the envoy of being “biased” and ill-informed.

South Korea touts Kaesong as a model of co-operation and reconciliation, benefiting South Korean manufacturing and staving off the implosion of the North's economy. It believes projects like the industrial park encourage reform in the communist state, paving the way for integration of the two economies and perhaps even reunification. It dreams of employing 350,000 people in Kaesong by 2012.

But there is a cost. The handful of South Korean companies currently operating in Kaesong pay the North Korean government to employ almost 7,000 North Koreans, who southerners say take home about $35 a month, well above the average monthly wage for the rest of the North. However there is no freedom of association, industrial action or direct wage negotiations.

The American administration is determined to make human rights a big part of its North Korean agenda, and besides thinks that Kaesong's success is helping to prop up the northern regime. Other potential investors, wary of getting involved in a scrap with the Americans over the exploitation of workers, are hanging back. Kaesong is not yet cleared for take-off.

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Turkmenistan

Inside the mad despot's realm

May 25th 2006 | ASHGABAT AND MARY
From The Economist print edition

A rare visit to one of the world's most secretive and repressive countries

THERE is not much to laugh about on state television in Turkmenistan. But viewers may be forgiven for feeling a little quiet satisfaction at the spectacle, late last month, of Gurbanbibi Atajanova, the former chief state prosecutor otherwise known as the iron lady, tearfully begging not to be sent to prison after being accused of possessing 25 houses, 36 cars and 2,000 head of cattle. Ms Atajanova led the purges that, in recent years, systematically removed anyone who tried to challenge, or simply to rein in, President Saparmurat Niyazov, the self-styled Turkmenbashi, or "father of Turkmen".

Not, of course, mentioned by state television was the fact that, on the very same day, Mr Niyazov was himself under attack. A London-based human-rights organisation, Global Witness, was accusing him of siphoning off most of the country's estimated $2 billion a year in gas revenues and concealing them in offshore accounts. One of these contains $4 billion, alleges one well-informed insider.

Such topics cannot be discussed in Turkmenistan. Any criticism or dissent is defined as treason and is punishable by long prison terms, confinement to psychiatric hospital or internal banishment, mostly to arid salt flats by the Caspian Sea. Private conversations everywhere are monitored by eavesdropping informers, as well as bugs and phone-taps. E-mails are monitored (there is only one service-provider) and internet access rare: a trawl of the capital reveals not one functioning public outlet. Surveillance, already tight, has been ratcheted up after a failed coup attempt in 2002.

Yet there is much that needs to be discussed. Ashgabat, the capital, is a surreal showpiece of grandiose, neo-Stalinist buildings of gleaming white marble, with giant portraits and gold statues of the Turkmenbashi everywhere—including one, arms aloft, that constantly revolves through 360 degrees, so that it always faces the sun. Behind the glitz lies a grim reality; rutted tracks leading from four-lane highways to windowless, one-room homes, including converted railway containers, surrounded by debris and animals. Some of these are inhabited by those whose homes—and entire neighbourhoods—were razed to make way for "renovation" and offered no compensation. In one, a middle-aged woman struggles to bring up her nephew (her sister, a heroin addict like many in Turkmenistan, is too ill). But Olga has lost her job under new laws because she is of Armenian and Ukrainian descent.

Facing the sun, presiding over ruin

Such are the priorities of a regime that squanders money on prestige projects of dubious benefit, including an ice-rink, a huge half-finished artificial lake, vast mosques, gold-domed palaces and soon a new zoo, complete with penguins, in a country where the summer temperature tops 50°C. At the same time, public health and education—the only worthwhile legacies of the Soviet Union, from which Turkmenistan became independent in 1991—have been all but dismantled.

This year's outlook is even grimmer than last's. In January, 100,000 people had their pensions cancelled, those of another 250,000 were severely cut back, and sickness and maternity benefits were ended. Unusually, the decrees led to protests, including demonstrations in the port town of Turkmenbashi, while a Niyazov statue in the city of Mary (once known as Merv) had its arm sawn off and a bucket of human faeces thrown over it.

Then, in April, Mr Niyazov announced a further "reform" to the already crippled health service, adding new charges that will make its few remaining services yet more inaccessible. Most hospitals outside the capital have closed and the remainder offer only rudimentary care, lacking staff, equipment and medicines, condemning thousands to death from common, treatable illnesses such as tuberculosis.

And education is even worse

Every Monday at 8am, Turkmenistan's schoolchildren line up to recite the oath of allegiance to the president, part

of a youth-indoctrination programme that is progressively replacing the conventional curriculum. Its core is the two-volume *Ruhnama,* “The Book of the Spirit”, a homespun collection of thoughts on Turkmen history and culture that pupils are required to spend hours studying. Visits to bookstores reveal shelves lined with nothing but the president's works. Meanwhile, mandatory education has been reduced from ten years to nine and most rural kindergartens have closed, as have all libraries outside the capital. Russian-language teaching has been largely phased out, music and ballet schools closed and almost all teachers of ethnic-minority origins sacked under rigorously enforced “Turkmenisation” policies that demand racial purity, traceable back three generations, for all workers in state institutions, including hospitals.

Higher education is severely run down. The annual intake is now under 3,000, a tenth of the pre-independence figure, courses have been cut to two years and standards are so poor they are unacceptable abroad. Worse, the president has ordered that no foreign degrees will henceforth be recognised. Anyone with a qualification gained abroad is either being sacked or refused a job. One economist says that all but two of her high-school class of 30 have emigrated because they see no future at home. “You have students returning with degrees from the world's best universities—MBAs from Stanford, for instance—who can't get jobs,” she says. “We are the last educated generation,” sighs another professor.

In rural areas, the problems are different. Cotton is the main crop, but the past three harvests have been catastrophic because of a requirement to sell at state-set prices so low that farmers are left with annual incomes of around $100. Unemployment is estimated at over 70%, exacerbated by public-sector layoffs, and by laws restricting job-seekers to their home towns. Such is the pressure to obtain work that bribes are standard. Even the scarf-swathed army of women sweeping Ashgabat's streets with twig brooms have to pay officials, Turkmen say.

Despite widespread unhappiness with the regime, most Turkmen do not see a way out. Rebellion looks impossible, given the level of repression and fear; and state benefits (free gas and electricity and highly subsidised fuel, since plentiful gas and oil are Turkmenistan's only blessing) take some of the edge off discontent. Besides, people are brainwashed by a relentless propaganda machine orchestrated by four state-television channels, two radio stations and several newspapers propounding the idea of a “golden age”. Exiled opposition groups have little influence, and pressure from the outside, given Turkmenistan's large mineral reserves, is shamefully muted.

There is, though, much speculation about the 66-year-old Turkmenbashi's health. He has had heart surgery, and has a team of eight top-notch German doctors constantly on call. This raises other problems, most obviously the lack of a mechanism for an orderly transfer of power, coupled with the lack of any democratic tradition in a conservative, tribal society. Pessimistic Turkmen fear that a lost generation, uneducated beyond the *Ruhnama*, may fall prey to Islamic radicalism—and create a nasty failed state that could destabilise an already volatile region. A fine mess for a father to leave to his children.

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Correction: Taro Kano

May 25th 2006
From The Economist print edition

Due to a production error, last week we referred to Taro Kano, a candidate for Japan's LDP leadership, as Tara Kano. Many apologies.

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Israel and the United States

Yes, but

May 25th 2006 | JERUSALEM
From The Economist print edition

Israel's new prime minister basks in American praise, with strings attached

DID he get what he wanted? This week Ehud Olmert went to Washington, DC, for his first meeting as Israel's prime minister with George Bush (they had met before as mayor of Jerusalem and governor of Texas). The visit looked like a roaring success. Mr Olmert spent plenty of time with the president and enjoyed the rare honour of addressing Congress. The two leaders said they shared the same view about the need to stop Iran acquiring nuclear weapons. Mr Bush repeated a promise that the United States would “come to [its] aid” if Israel were attacked. To top it all, Mr Bush praised as “bold” Mr Olmert's plan to adjust Israel's borders unilaterally if attempts to do so by negotiation with the Palestinians came to naught.

Mr Olmert, a perfect guest, expressed his effusive appreciation. But whether he really got all he wanted is hard to say. He told Congress that a nuclear-armed Iran would pose “an existential threat” to the Jewish state. He may have received private reassurances from Mr Bush that Iran would somehow be stopped. But a vague American promise to defend Israel will not quieten mounting anxiety back home. Indeed, Mr Bush's defence guarantee may have been designed as much to restrain Israeli actions—whether a pre-emptive strike, or a change in its own policy of nuclear ambiguity—as to deter Iran's.

By the same token, Mr Olmert has not yet received everything he once hoped for from Mr Bush on the Palestinian front: a diplomatic green light, and practical help, for his plan to abandon Israel's outlying settlements in the West Bank and incorporate the main Jewish settlement blocks in new borders that America would endorse as final. Mr Bush welcomed Israel's unilateral plan as a step towards a two-state solution if Hamas, the Islamist government of the Palestinian Authority (PA), sticks “in the period ahead” to its refusal to recognise Israel's right to exist or to renounce violence. But first Mr Bush wants Israel to try to negotiate with Mahmoud Abbas, the PA's non-Hamas president. Only if that effort fails, it seems, will the Americans agree to let Israel fall back to borders of its own choosing. And even then, Mr Bush implied, those borders would not be final until they are settled by negotiation.

As to how long “the period ahead” should be, Haim Ramon, the justice minister, said Israel could start implementing the plan by the end of this year. Hamas, for its part, has not moved any closer to meeting Mr Bush's and Mr Olmert's conditions for lifting the political and economic blockade of the PA. It still talks in terms of an indefinite truce rather than firmly accepting Israel's existence. As the blockade bites, the PA, with a nearly three-month backlog in salaries, is beginning to shut down, and tensions are rising on the streets of Gaza between armed men from Hamas and Mr Abbas's Fatah party.

On May 25th, Mr Abbas delivered a surprise. He said that unless within ten days Hamas recognised Israel's right to exist within its pre-1967 borders, in accordance with a proposal drafted by Fatah and Hamas members presently in Israeli jails, he would put the proposal to a referendum. Whether Hamas's leadership could endorse such an idea is not clear. But even if it did, the Israelis would not be impressed. The prisoners appear to suggest talking to Israel

only after it gives up all of the territories occupied in 1967—an absurd non-starter from its point of view.

Roadblocks ahead

In short, after a “period ahead” of waiting for a peace partner, Mr Olmert could still be free to get on with his withdrawal plan. But it will not be easy. His Kadima party did not receive an overwhelming election mandate. Pulling 8,000-odd settlers out of Gaza cost the taxpayer around 8 billion shekels ($1.8 billion). To rehouse 60,000-70,000 from the West Bank, Israel may require help. It will also, says Lior Horev, an adviser to Kadima, need America's approval for moving some of them into the settlements that Israel intends to keep and for expanding those settlements. And it will need to persuade the settlers that they will not face the fate of many Gaza evacuees—bad housing, broken communities and trouble finding work.

Moreover, time may be short. Mr Bush leaves office in 2008, and Israel cannot count on his successor's support—nor on that of Kadima's partners in its coalition government. Mr Horev thinks that Labour, the next-biggest party, which supports the withdrawal plan but has a more leftist social agenda, might start attacking Kadima's economic policies as early as autumn of next year, in the hope of forcing and winning an early election. To stay unassailable, Mr Olmert will need by then to have prepared not only the details of the plan, but all the means to carry it out.

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Iraq's government

Could it prevail?

May 25th 2006 | DUBAI
From The Economist print edition

A new government has only a few months in which to stop the killing

Get article background

AP

Happiness is a sectarian carve-up

AFTER six months of wrangling, a national-unity government that embraces genuine representatives of all Iraq's main religious and ethnic groups has emerged under a new prime minister, Nuri al-Maliki. The American administration insists that the event marks a hopeful turning point. After a visit to Baghdad this week, Britain's prime minister, Tony Blair, is likewise said to be convinced that there is at last a real hope that the government may impose itself. All the same, its chances of stemming the insurgency and bringing the minimal stability to allow for the withdrawal of American troops and their allies still look only middling at best.

As he unveiled his team, Mr Maliki (pictured, left) sounded doggedly upbeat, insisting that Iraqis would now more rapidly take over full responsibility for the country's security. In the next two months, the British would hand over two of the four provinces they control in the south. Except for Baghdad and the out-of-control western province of Anbar, where the Sunni insurgency is fiercest, Iraqi forces should—he said—handle security in the rest of the Iraq's 18 provinces by the end of the year. Meanwhile, Iraq's fledgling forces would hit the rebels with “maximum force”.

In truth, no one knows whether the new government will manage to impose itself any better than the previous one, under Mr Maliki's ineffectual predecessor, Ibrahim al-Jaafari. The best guess in Baghdad is that Mr Maliki has less than a year, perhaps only six months, in which to reverse the tide of sectarian carnage and chaos that now grips nearly all the Sunni Arab parts of the country, especially cities with mixed populations, such as Baghdad, Mosul and those in between, along the valleys of the Tigris and Euphrates rivers.

As in the previous government, the main Shia block, the Islamist-minded United Iraqi Alliance, has the lion's share of top jobs, including the prime ministry. But, to acknowledge the high Sunni Arab turnout in last December's general election, Mr Maliki has brought all parliament's main groups into his government, including the largest Sunni Arab one, a clutch of Islamist-oriented parties known as the Iraqi Consensus Front, which broadly sympathises with the insurgents. Still, the fact that Mr Maliki has been unable, as yet, to fill the crucial ministries of defence and interior (now in temporary hands) bodes ill for the new government's hoped-for unity. At least, as a sop to the disenchanted Sunni Arabs, he has sidelined the previous interior minister, Bayan al-Jabr, a Shia who was widely accused of winking at sectarian murders committed against Sunnis by militias acting under cover of his ministry.

In any event, the government is a sectarian carve-up, with most groups still likely to view the ministries they have been allocated as vehicles for patronage. The main Shia alliance retains the oil ministry, though it has been reassigned to a respected scientist, Hussein al-Shahristani, in the hope that he will put national interests above those of his Shia co-religionists.

The Shias' dominant alliance will also control most of the “service ministries”, such as health, education and transport, promoting itself as ordinary Iraqis' chief benefactor. On this score, a radical Shia cleric, Muqtada al-Sadr, who has the largest number of followers in parliament's Shia alliance, has gained ground.

The Kurds have continued to do well. As well as holding the national presidency, they will keep the foreign ministry. More to the point, as Shia and Sunni Arabs argue bitterly over the shape of Iraq and who should run it, the Kurds are steadily entrenching their autonomy in the north and may soon succeed in formally incorporating most of the disputed oil-rich Kirkuk province into their domain.

As a prerequisite for drawing more Sunni Arabs into peaceful politics, Mr Maliki knows he must fast set about tweaking last year's new constitution to ensure a fair distribution of oil revenue to oil-deprived Sunni provinces and to reassure Sunnis that decentralisation will not mean leaving them in a fly-blown Iraqi rump state.

The real question is whether new ministers hailing from the Sunnis' Consensus Front (perhaps including the defence minister) will persuade many insurgents to lay down their arms. So far, the omens remain poor, though informal contacts are said to have been sporadically opened. For one thing, the insurgency is highly fractured, though some American and Iraqi commanders believe there is scope for deals with local guerrilla leaders and tribal sheikhs that might lead to wider ceasefires. For another, it is clear that, while some of the more nationalist-minded rebel groups may be prepared to give Sunni ministers in the government at least a chance to parley, those who draw inspiration from al-Qaeda or follow its self-proclaimed leader in Iraq, Abu Musab al-Zarqawi, certainly are not. Worst of all, the sectarian tit-for-tat may already be so out of control that no ministers in the new government, whether Shia and Sunni, have a chance of holding back the militias that have become a law unto themselves.

In the previous government, Shia ministers argued that militias had a legitimate role in keeping order alongside the security forces. Mr Maliki, however, in a hopeful change of tack, says that all weapons must be in the hands of the state. He has also discussed integrating militias into the armed forces—a suggestion hitherto rejected by Sunni Arabs—or unifying the country's myriad security agencies into a single force. However, as the ethnic cleansing and communal bloodletting proceed and people still look to the militias as their last line of protection, such worthy ideas are unlikely to be heeded soon.

We'll stand alone

Mr Maliki's hopes of a rapid withdrawal of American and allied foreign troops also look unlikely to be fulfilled as early as he wants. A retired American general, Barry McCaffrey, recently argued that, while Mr Maliki's failure might bring the country to full-blown civil war in a matter of months, the new Iraqi army needed strong combat backup from the Americans for at least another two, and maybe as many as five, years, before it could stand on its own feet.

So why the optimism? The highest hope, for Mr Maliki and his team, is that, as the Iraqi forces begin to assert themselves against the insurgents, a stand-off may slowly ensue, allowing Sunnis and Shias in government to reach out to the more amenable of the rebels. Mr Maliki's mammoth task would then be to persuade the Sunni minority to accept a humbler role in a decentralised state and to urge the Shia majority genuinely to share power with its former Sunni oppressors as the price of containing the rebels.

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Egypt

Forwards, backwards

May 25th 2006 | CAIRO
From The Economist print edition

Economic reform is going ahead, but the political kind is lagging well behind

Get article background

"WE ARE determined to stay the course of reform," declared Gamal Mubarak, the well-groomed son of Egypt's president, who also heads the ruling party's politburo. "What he means is, 'We are determined to stay'," hisses a voice in the audience.

Reuters

Controlled democracy

That says much about Egypt's dilemma. The view from the peak of the power pyramid is sunny. Two years after a cabinet packed with the younger Mubarak's cohorts replaced ministers of his father's risk-averse generation, the macroeconomic picture is brightening. Egypt's economy is growing at close to 6% a year. Inflation is low. The current account is well in the black, the surplus set to rise as conduits for exporting Egypt's abundant natural gas come on stream. Foreign investment, much of it from the oil-flush Gulf, is expected to touch $6 billion this year, triple the level of three years ago.

But the view from Cairo's crowded streets is far darker. Speeding growth has yet to lift living standards for the masses, even as needed further reforms, such as cutting costly subsidies on such things as fuel, threaten a tighter squeeze. State schools, universities and hospitals that were once free have worsened; often, only private courses or fee-paying sections provide a decent service. For many, meat has become a luxury.

Much-touted political reforms have so far produced similarly paltry rewards. Last year's first-ever contested presidential election, and subsequent voting for parliament, stirred lively debate and earned plaudits from afar. Yet the results they delivered were much the same as before: a low turnout amid widespread fraud, and the return of the same president and party that have ruled for a quarter of a century.

It is true that the opposition, most significantly the Muslim Brotherhood, won an unprecedented fifth of parliament's seats. But since those elections, the government's taste for experimentation has soured. Instead of investigating electoral fraud, it has disciplined whistle-blowing judges. Municipal polls set for this spring were abruptly cancelled. Emergency laws that allow for arbitrary arrest, and which Mr Mubarak had promised to amend, were instead extended for two more years. Hundreds of Muslim Brothers have been rounded up and jailed under varied pretexts. The closest challenger to Mr Mubarak in the presidential race, Ayman Nour, a secular-minded lawyer who won 8% of the vote, languishes in prison, having lost a final appeal against a five-year prison sentence on charges of forgery.

Most visibly, recent weeks have seen a return to the use of brute force against street demonstrations, after a period of relative leniency that had encouraged the spread of such protests. Repeatedly, small groups of demonstrators in central Cairo have been blocked by serried ranks of riot police, then charged, beaten and dragged

off singly by young, club-wielding plainclothesmen. Some 400 peaceful protesters are now in prison under the same emergency laws that ministers say are wielded only against terrorists and drug-runners.

Foreign visitors are often told, by way of excuse, that such protests are being manipulated by the Muslim Brotherhood, a group that remains formally banned, and that Egyptian officials privately tend to regard as anathema. With Western fears of Islamism lately heightened by the electoral success in Palestine of Hamas, a Brotherhood offshoot, the expectation is that such excuses will find an understanding ear. But Egypt's rulers have been discomfited instead by Western criticism, most recently in America's Congress, where moves to slash $1.3 billion in annual American military aid, by as much as $200m, have been proposed.

President Bush's administration opposes such wrist-slapping, pointing to the 78-year-old Mr Mubarak's pledge to pursue reforms at his own pace, and to Egypt's crucial part in securing regional stability. But in Egypt, the balance between stability and the “forward strategy of freedom” that Mr Bush has promoted in the region is looking increasingly hard to maintain.

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Zimbabwe

Can it get worse?

May 25th 2006 | JOHANNESBURG
From The Economist print edition

Zimbabwe's downward spiral

THIS month marks a sad anniversary in Zimbabwe. A year ago, the government launched Operation Murambatsvina ("drive out the rubbish"): about 700,000 urban people had their homes or businesses destroyed. In the past year, conditions have worsened. Inflation has passed 1,000%; at least 75% of Zimabweans probably have no jobs; food and fuel are scarcer than ever. Some 3m people are thought to have left the country. There has been a new wave of arrests and intimidation. Is any hope left?

Not if it is pinned on the official opposition. After weathering years of repression, the Movement for Democratic Change (MDC) is utterly split. Both its factions fielded candidates last week in a by-election in Harare, the capital. The one led by Morgan Tsvangirai, the movement's veteran leader, easily beat President Robert Mugabe's ruling ZANU-PF, while a rival MDC group headed by Arthur Mutambara did dismally. Mr Tsvangirai is threatening to take his opposition to the streets, but, given the rows in his party, he may struggle to muster enough supporters to avoid being crushed by the country's powerful security forces.

In any case, civic groups, churches and the trade unions have taken over from the MDC as Mr Mugabe's real opposition. The National Constitutional Assembly, a pressure group, organised a march last week in Harare; a church group led another in Bulawayo, Zimbabwe's second city, to commemorate the clean-up operation; and the Zimbabwe Congress of Trade Unions is leading protests against the dive in living standards. The Crisis in Zimbabwe Coalition, an umbrella body for protesters from all walks—including churches, trade unions, women's and student associations—may be best placed of all to tackle the government. But though such groups have recently been livelier than the stricken MDC, they too have been shaken by the party's squabbles.

Who can glue the discontent together to bring change? Despite the recent resurgence of opposition from beyond the divided MDC, brewing internal dissent within Mr Mugabe's own ruling party may yet be the final cause of his downfall. But when?

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Germany's government

A cumulus of discontent

May 25th 2006 | BERLIN
From The Economist print edition

Doubts are growing about Angela Merkel, at least at home

NOT a bad week, Angela Merkel, the German chancellor, may have thought as she flew back to Berlin from this week's whirlwind visit to China. Once again, she had cut a good figure abroad by being both friendly and firm in Beijing, not least over human rights and Iran's nuclear programme. Before she went, the Bundestag, the parliament's lower house, had passed her tax plans. Even better, economists now say that Germany's upswing could become self-sustaining, as consumption and investment recover.

But Ms Merkel had little time to dwell on the good news. A host of problems awaited her in Berlin, suggesting that, after six months in office, her government may no longer be given the benefit of the doubt. The tone within the grand coalition of Christian and Social Democrats has become rougher. Worse, critics say that the government is doing nothing but raise taxes, because Ms Merkel's light-touch leadership is in fact the result of a lack of clear plans. To stop the clouds building, she must get through some reforms worthy of the name, notably in health care.

A shift in the political climate in Germany was perhaps to be expected. Thanks to more competition and a new generation of journalists, the media are now more aggressive than they used to be. What is more, those who supported Ms Merkel and her more radical reform ideas before last year's elections are starting to show their disappointment. Germany's leading weekly, *Der Spiegel*, now frequently lays into the government for its failings.

Albeit mostly in private, business leaders are starting to complain that they do not understand what is going on. Some Christian Democratic politicians, especially state premiers, are publicly wondering whether the coalition is really worth the hassle. Economists are calling for faster reforms. Even Horst Köhler, the federal president, who owes his own job to Ms Merkel, has become cautiously critical of her government. Two-thirds of Germans are said to be unhappy with the government's performance, even though a similar proportion still think that Ms Merkel herself is doing a good job.

Is the grand coalition getting stuck before it has really got started? To find the answer, it helps to keep in mind the government's original programme. In its first few months, it did not want to move too quickly. Its priority was to create calm after last year's political turmoil, to avoid bickering and to make time for repairing the public finances. Measured against these aims, the results are modest but reasonable—although more spending cuts would have been better than sticking to the decision to raise taxes.

Only in recent weeks has the coalition begun to discuss harder reforms. Besides health care, these include corporate-tax reductions and more labour-market reforms. In none of these will it be easy to find a compromise that is any better than the lowest common denominator. In health care, for instance, Christian Democrats want to start decoupling contributions from wages by introducing a small flat-rate premium. But the Social Democrats want

to keep the link to pay, and to tax other types of income to boot.

The crunch will come this autumn, when Ms Merkel and her Social Democratic vice-chancellor, Franz Müntefering, may need to engage in some serious horse-trading. If they fail to strike a deal, post-war Germany's second grand coalition risks going down in history as a failure, for there will be little time to put things right before the end of its term. In the first half of 2007, much of Ms Merkel's energy will be absorbed by her presidencies of the European Union and the G8 big-country group. By early 2008, Germany will be in a period of permanent campaigning: a string of important state elections will lead up to a federal election due by September 2009.

One reason why many observers are so pessimistic is that the coalition has shown little ability to strike sensible compromises. A case in point was the “parental payment”, a new benefit meant to encourage families to have children, with a specific incentive for fathers to take two months of parental leave. After resistance to this “nappies internship” within the Christian Social Union, the Christian Democrats' socially conservative Bavarian sister party, the benefit was extended at greater cost. More recently, the Social Democrats got a stricter anti-discrimination law only by accepting extra tax breaks for farmers, many of them Bavarian.

As tensions between the parties increase, political management is getting worse. The anti-discrimination law ran into loud criticism among Christian Democrats, for whom such legislation is a prime example of unnecessary red tape—and another sign that they are losing their political identity. To calm their anger, Ms Merkel had to commit her first unfriendly act against her coalition partner, calling the Social Democrats “averse to change”, a compliment they promptly returned. The Christian Democrats are also about to lose one of their best parliamentary leaders, Norbert Röttgen. Last week, he announced that he would become director-general of the Federation of German Industries at the end of the year—a switch of jobs that was widely interpreted as the decision of a man who had lost faith in the possibility of significant change.

The danger for Ms Merkel is that, unless she makes big progress with reforms, such episodes could create a “cloud of discontent” over the government, in the words of Wolfgang Nowak, head of the Alfred Herrhausen Society, Deutsche Bank's think-tank. Yet even if heavy political weather turns the grand coalition into an increasingly painful affair, it would be wrong to expect either partner to leave. That would probably trigger a new election. As long as the Germans remain undecided about whether they are ready for more reforms or prefer to keep muddling through, a new vote could well produce the same inconclusive result as the last one.

Even so, it may be time to change the prevailing perception of Ms Merkel. It has long been the conventional wisdom that it would be a mistake to underestimate her. This is still true, but the high expectations that exist for her government, at home and (especially) abroad, may nonetheless prove hard to live up to. The weekly *Die Zeit* recently argued that, whatever the risks of an underestimate, one should also not overestimate what the chancellor can do, at least with her present coalition.

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German neo-Nazis

Welcome to no-go land

May 25th 2006 | BERLIN
From The Economist print edition

A nasty outbreak of violence in eastern Germany

Get article background

HOSTING a big sports event can be both a blessing and a curse. This summer's football World Cup is a chance to show that Germans are not just efficient, but also creative. Government and business have teamed up to sell the country as the “land of ideas”. Yet Germany's darker corners have also been catching the world's attention.

The most recent examples are a spate of racist attacks by neo-Nazis, and a statement by Uwe-Karsten Heye, a former government spokesman, that there are areas into which non-whites should not venture because they “may not leave alive”. His remarks were dismissed as an exaggeration. Yet, almost as if to prove his point, on May 19th a politician of Turkish origin was badly beaten in Lichtenberg, a district of eastern Berlin known as a neo-Nazi stronghold. A few days later the courts provoked further murmurs when they released some right-wing suspects charged with violence for lack of evidence.

Right-wing extremism and racist violence are a continuing concern. A government report says that some 10,000 neo-Nazis are “ready to use violence”. They were responsible for nearly 1,000 acts of violence in 2005, a rise of almost a quarter over 2004. Most of these happened in eastern Germany, particularly Saxony-Anhalt and Brandenburg. The capital is split: travel guides have long advised gay- or foreign-looking tourists to avoid parts of eastern Berlin.

Yet it would be wrong to see these areas as ghettos with hordes of neo-Nazis roaming the streets. Lichtenberg and Marzahn are not South Central Los Angeles or the Bronx in New York. Nor is it true that nothing has been done to tackle the problem. Compared with the early 1990s, when neo-Nazi violence emerged, things have improved. The police take the threat seriously. Although underfinanced and overwhelmed, many non-governmental groups offer help, such as counselling victims or advising local officials.

Some politicians, particularly on the right, play down the subject, either because they do not want to alienate right-wing voters or for fear that talking about it may hurt their region's image. Conversely, when racist violence has pushed itself onto the agenda, others indulge in shrill warnings, such as the claim that neo-Nazis will use the World Cup to damage Germany's reputation. With luck, it will not come to that.

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The Balkans

Enter Montenegro

May 25th 2006 | PODGORICA
From The Economist print edition

Reuters

A minnow emerges

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FOR a country that has just voted to become independent it is surprising how many people are fretting. On May 21st Montenegrins voted to divorce from Serbia. Immediately after the first results were announced, the sky over Podgorica, the tiny capital, was lit up with fireworks. Jubilant crowds came out onto the streets. With their girlfriends perched precariously on car roofs, young men drove around town in victory laps. The next morning, Montenegrin television repeatedly showed Milo Djukanovic, the prime minister, celebrating with champagne.

And yet, as the festivities died down, a distinct note of complaint started to be heard—and not just from those who had voted to keep the union with Serbia. Serbia and Montenegro have been linked in the same state since 1918. Montenegro's secession is one of the last acts of the dissolution of the old Yugoslavia that began 15 years ago. It is not the very last. Within a year, Kosovo, the mostly ethnic-Albanian province that is technically part of Serbia (which Montenegro was not) will also probably gain its independence.

Several things were striking about the referendum. First was the absence of conflict or violent incidents, in a highly divided society. According to the official results, 55.5% voted for statehood, and 44.5% voted to keep the union. That is a solid margin by any standard. Pro-union leaders say that Mr Djukanovic's supporters cheated, and that they will not recognise the result. But although they will lodge formal complaints, independence now seems a fait accompli.

The European Union had insisted that, for recognition, more than 55% had to vote in favour. This figure was reached, but only just. Montenegro has only 672,000 people, so it took only a little over 2,000 to tip the result. Unionists say that the government somehow found a way of financing the return of thousands of Montenegrins from abroad who were in favour of independence. Some of this was sour grapes. Serbian railways gave free tickets to mostly anti-independence Montenegrins living in Serbia to go home to vote.

Despite its size Montenegro has significant economic potential, especially in tourism. Now, however, some hard realities are beginning to sink in. Many people who supported independence loathe the 44-year-old Mr Djukanovic, who has been in power for 17 years. They believe that too many people around him have got suspiciously rich over the past decade.

Mr Djukanovic's position is hardly under threat. Igor Milosevic, a political analyst, says simply that “Milo will be king now.” An election will be held this autumn. The main opposition parties have lost their prime reason for existence, which was to preserve the union. Predrag Bulatovic, leader of the largest pro-union block, may now resign; if he does, the opposition will lose one of the few people able to turn the party into a normal post-independence, social-democratic party. In June a new party will emerge, led by Nebojsa Medojevic, an economist.

He hopes to gather support on the basis that he is for independence but against Mr Djukanovic, whom he accuses of creating “a Colombia on the Adriatic, a paradise for tycoons.”

Mr Medojevic surely exaggerates. And Mr Djukanovic is a phenomenally clever politician, with an unerring instinct for survival. In the early 1990s he was a Serbian nationalist. Today he is hailed by many as the man who delivered independence from Serbia. But now he needs to do something else: deliver the fruits of independence to ordinary people.

Many of Montenegro's economic indicators are good, but most people do not see the results. Average salaries are a mere €250 ($300) a month, and unemployment is running at 18%. A good many Montenegrins were not all that worried about independence; they just wanted the issue resolved so that the government could start delivering something for ordinary people. There is a lot of work to be done in Europe's newest state, and it needs to be done fast if it is to join the EU any time soon.

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Turkey's troubles

Secular worries

May 25th 2006 | ANKARA
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A spat with a general proves upsetting

“THERE is a price for each word uttered by people in responsible positions,” said Recep Tayyip Erdogan. The Turkish prime minister was talking about an unprecedented outburst by the chief of the general staff, General Hilmi Ozkok, after last week's shooting in a courtroom in Ankara that killed one pro-secular judge and wounded four others. The general had called the anti-government demonstrations that followed “admirable”.

Alparslan Arslan, a 29-year-old lawyer who was the gunman, said he had picked on the judges because they supported the ban on the Islamic headscarf in public offices, schools and universities. Members of the cabinet, including the foreign minister, Abdullah Gül, and the justice minister, Cemil Cicek, were called “murderers” by thousands of pro-secular Turks, who flocked to the city's main mosque for the judge's funeral on May 18th. Mr Erdogan was pilloried for not being there.

A day later President Ahmet Necdet Sezer marched with generals, university rectors and some 20,000 protesters to Ataturk's mausoleum. It was the biggest pro-secular rally since the 1993 murder of a columnist on a secular daily, *Cumhuriyet*. “Turkey is secular and will remain secular,” shouted the marchers. But will it? That has been the worry of millions of Westernised Turks ever since the mild Islamists led by Mr Erdogan, came to power in 2002 with a big majority.

The secularists' fears have been exploited by the army, whose powers are being steadily eroded by a string of reforms made necessary for Turkey to win its prized start of membership talks with the European Union last October. Mr Erdogan's supporters blamed agents of “the deep state” of rogue security officials and bureaucrats for last week's attack. Their aim is said to be to torpedo the EU process, weaken the government and bully Mr Erdogan into ditching his ambitions to succeed Mr Sezer when he retires next year.

Mr Arslan's bizarre web of connections suggest that he did not act alone. His alleged accomplices include a former army captain, who was dumped at an Istanbul hospital with self-inflicted knife wounds after the killing, and sundry ultra-nationalists involved in extra-judicial killings, extortion rackets and attacks against Christians and Kurds. But even if the affair proves to be a conspiracy, Mr Erdogan still needs to ask himself why so many Turks blamed the government.

One reason may be that, just like his pro-secular critics, Mr Erdogan has been decidedly selective in his sense of democracy and justice. He has loudly denounced court rulings against the headscarf. Yet, when an Istanbul prosecutor pressed charges against the country's best-known author, Orhan Pamuk, for speaking about the mass killings of Armenians by the Ottomans in 1915, Mr Erdogan did not utter a squeak of reproach. His claims to defend the interests of all Turks, not just religious ones, are beginning to ring hollow.

Yet those who are baying for the government's blood should think twice as well. For all his shortcomings, Mr Erdogan has brought Turkey greater freedom and stability than any of his pro-secular predecessors. His attempts to increase Islam's visibility in public life have remained just that. Although a recent poll suggests that Mr Erdogan's popularity rating has slipped from 35% to 28%, his party still has twice as much support as the pro-secular Republican People's party. Indeed, the lack of a credible opposition remains one of Turkey's biggest weaknesses.

Should the judge's murder prove to be an individual act of retribution, “the implications are far more worrying than those of a conspiracy,” says Murat Erdogan, at Ankara's Hacettepe University. “That could mean there will be further such incidents, whereas conspiracies can be unveiled and brought under control.”

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Demography in eastern Europe

Red fades to grey

May 25th 2006
From The Economist print edition

Ex-communist countries risk growing old before they become rich

POOR countries have high birth rates. As they get richer, family size drops. That is a handy rule of thumb, but one that post-communist Europe is disproving. The worst outlook is in such places as Ukraine and Bulgaria, where the population is expected to fall sharply by 2025 (see chart). In the Baltic countries of Estonia and Latvia, demographic prospects are bleak too, but their economies are rather stronger.

But everybody, including such relatively rich countries as Hungary and the Czech Republic, should be worried. As the World Bank argues in "The Third Transition", a study that will be published later this year, old populations tend to mean slower growth. There are fewer workers. Oldies are (on average) less productive. Health-care and pension bills rise.

Bad demographics are a communist-era fluke. Female fertility normally drops when wealth and education rise. Communism created the odd combination of women who were educated to rich-world standards, but lived in countries left destitute by the collapse of central planning. Women in communist countries also bore their children young, typically in their early 20s. Choosing to have fun and make money like their rich-country sisters has cut the birth rate, at least temporarily. In Poland, the commonest age for bearing a first child was 22 in 1989. By 2001 it was 26.

This is aggravated by instability and corruption in the poorer post-communist countries. Having wasted the past 15 years, they now lag behind their counterparts, face greater difficulties and are less able to pay for them. It is not all hopeless. But the demographic outlook makes faster growth and reform a lot more urgent. Empty places in schools, for example, should make it possible to put more money and effort into the task of sorting out universities, which are mostly dire: cash-strapped, corrupt and old-fashioned.

Experience in Estonia suggests that the right incentives can help. Generous parental leave introduced in 2003 brought an immediate rise in births, with 800 more babies born in 2004 than in 2003, and 1,200 more in 2005. The government is introducing subsidised in-vitro fertilisation. It needs to: its measures so far have slowed the population decline, but been nothing like enough to reverse it.

It may be more practical to attempt to get rich more quickly than to grow old more slowly. But even here the post-communist countries have plenty to do. New forecasts published this week by the European Bank for Reconstruction and Development suggest that average annual growth in the 27 countries that it covers is likely to be only 4.5% between 2007 and 2012 , down from 6.7% in 2004 and 5.6% in 2005. That, argues Erik Berglof, the bank's chief economist, is because foreign direct investment—the biggest contributor to growth—was unusually high in recent years and will now fall. "The cost advantage will level out quite quickly," he says.

That may be too gloomy: the best-governed countries still show surprisingly high growth and investment. But that will bring little comfort to their ageing and badly run neighbours.

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Religion in Finland

The sound of moulds breaking

May 25th 2006
From The Economist print edition

What this year's Eurovision winners tell us about modern religion

WHO said religion was dying in Europe? On paper at least, the Finns show a devotion to their national church that resembles new-world fervour more than the old continent's jaded scepticism. More than 4.4m people, or 85% of the population, are registered with the Lutheran church. Another 60,000 adhere to the Finnish Orthodox church, whose cathedral is a Helsinki landmark. By some indicators, the Finns are pious in fact as well as in theory: as many as 43% say they pray several times a week.

How odd, then, that the sugar-coated mould that has long encased modern Europe's greatest collective ritual—the Eurovision song contest—was broken by a group of Finns who set out, literally, to dress in the darkest of colours. “We are not Satanists,” insists Lordi, leader of a heavy-metal group that scored a surprise victory in this year's competition. But nor, to judge by appearances, are they Sunday-school teachers. Lordi sports red-eyed skulls on his knees, with horns rising from his masked face. “It's a big change from those catchy numbers for pretty girls in hopelessly untrendy outfits,” sighs John Vickers, a veteran writer of Eurovision songs for Cyprus.

AFP

No Sunday school for them

But how could the relatively God-fearing Finns allow such grotesque types to represent them? Part of the answer is that Finnish faith follows a Nordic model: a secular society combined with a state-backed church to which most people sign up, and pay taxes, because they want the clergy for weddings or funerals. That need not imply a deep belief in the tenets of Martin Luther. Like most Europeans, Finns are becoming more liberal over such things as euthanasia and homosexuality, and more free-wheeling in their beliefs. “Finns are neither very attached to religion, nor very opposed to it,” says Kimmo Ketola, a sociologist.

This sort of blandness may explain the appeal of mould-smashers such as Lordi. Ambrosius, the Orthodox bishop of Helsinki, sees in the hard rockers the seeds of something positive: a protest against cold rationalism and against modern sorts of idolatry—inspired, perhaps, by the earthy mysticism of Lapland, where Lordi springs from.

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Charlemagne

Snakes and ladders

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Europe is economically inflexible but socially mobile. Whence this strange combination?

EUROPEANS have mixed feelings about class. They deplore the idea that people may remain mired in poverty, and they have large welfare programmes to help them move up. They also resent the sight of rich families staying at the top for generations, and so impose high taxes to redistribute wealth and income.

On the other hand, compared with Americans, Europeans cling to a somewhat static view of society. They dislike the extremes of wealth and poverty that accompany America's supposed free-for-all meritocracy. They look askance at “excessive” job mobility, which breeds insecurity. Polls show that, compared with Americans, Europeans are more likely to dislike unfettered market competition and to believe that success is outside their own control. With some exceptions (eg, Dick Whittington), they lack the equivalent of Horatio Alger's myth of rags to riches. In short, in the European view, social stability is desirable, and if a certain amount of inflexibility is needed to underpin it, that is a price worth paying to avoid the restless uncertainties of America's market-driven model.

Yet the curious thing is that European society—at least in the Nordic countries—is far less stable than America's. Two new research papers* confirm that, if one compares the incomes of children with those of their parents, or considers how long people in one income group stay there, Nordic countries emerge as far more mobile than America. Britain shows more class stability than its northern neighbours, but it is still a lot closer to them than it is to America.

The authors rank countries on a scale from one to zero, with one meaning no mobility at all (ie, a child's income is identical to its parents') and zero meaning perfect mobility (ie, a child's income bears no relation to its parents'). The Nordic countries score around 0.2 for sons, Britain scores 0.36, and America 0.54 (meaning that a son's earnings are more closely related to his father's in America). These figures are roughly in line with the conclusions of other studies, though they have the advantage of using standardised data, thereby minimising problems of definition that usually bedevil cross-country comparisons.

The biggest finding of the studies is not, however, about overall social mobility, but about mobility at the bottom. This is the most distinctive feature of Nordic societies, and it is also perhaps the most significant difference with America. Around three-quarters of sons born into the poorest fifth of the population in Nordic countries in the late 1950s had moved out of that category by the time they were in their early 40s. In contrast, only just over half of American men born at the bottom later moved up. This is another respect in which Britain is more like the Nordics than like America: some 70% of its poorest sons escaped from poverty within a generation.

The Nordic countries are distinctive in one further way: the sons born at the bottom (into the poorest fifth) earn roughly the same as those born a rung above them (the second-poorest fifth). In other words, Nordic countries have almost completely snapped the link between the earnings of parents and children at and near the bottom.

That is not at all true of America.

Social mobility at middle-income levels is more similar everywhere (it is a bit higher in most European countries, but not by much). That may partly explain why Americans think their society is more mobile than it is (the middle classes tend to set the political agenda, and mobility is genuine enough for them). It may also explain why few Europeans appreciate quite how much movement up and down the income ladder there is, because much of it takes place off the radar screen of the politically influential.

Unwrapping the Scandinavian model

The obvious explanation for greater mobility in the Nordic countries is their tax and welfare systems, which (especially when compared with America's) deliberately try to help the children of the poor to do better than their parents. One might expect social mobility and economic flexibility to go together—in fact, to be two sides of the same coin. But to the extent that redistribution is an explanation, it implies the opposite: that social mobility is a product of high public spending, a bit like the low incidence of poverty or longer life expectancy (on both of which Europe also does better than America). But greater public spending tends also to be associated with less economic flexibility—which is why Nordic countries have sought to limit the more arthritis-inducing features of their tax-and-spend programmes.

Yet redistributive fiscal policies cannot be all there is to it. If they were, Nordic countries would not do as well as they do (their welfare states are not appreciably more generous than Britain's). The other part of the explanation seems to be their superior education systems. Education has long been recognised as the most important single trigger of social mobility—and all four Nordic countries do unusually well in the school-appraisal system developed by the OECD.

That in turn may explain why the bigger continental European countries, notably France, Germany, Italy, are not as mobile as Nordic ones. With relatively poor education systems, they are bound to perform more like Britain. But that still makes them socially (if not economically) more flexible than the land of the free. For Europe, the secrets of greater social mobility are, first, tough redistribution policies that particularly benefit those at the bottom; and, especially in Nordic countries, a more supple and less class-ridden education system, running from top to bottom. America could learn something from that.

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* “Non-linearities in Inter-generational Earnings Mobility” (Royal Economics Society, London). “American Exceptionalism in a New Light” (Institute for the Study of Labour, Bonn). Both by Bernt Bratsberg, Knut Roed, Oddbjorn Raaum, Robin Naylor, Markus Jantti, Tor Eriksson, Eva Osterbacka and Anders Bjorklund.

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Reforming pensions

A way out of the mess

May 25th 2006
From The Economist print edition

Alamy

A rare example of good policy-making from a troubled government

AFTER another wretched week, which featured yet more trouble at the Home Office and a big rebellion by Labour MPs over a bill to give state schools more freedom, Tony Blair savoured a rare political triumph. On May 25th, the government presented its long-awaited proposals to reform pensions. Despite strenuous early opposition from Gordon Brown, the chancellor of the exchequer and prospective prime minister, Labour now has a coherent plan to rebuild a pension system that it has done much to undermine.

That plan rests on the work of the Pensions Commission, which the government set up under the chairmanship of Adair Turner, a former director-general of the Confederation of British Industry. Ministers have largely accepted the three main recommendations that Lord Turner and his two fellow commissioners made last November.

First, the state-pension age will start rising from 65—the age for men now and for women by 2020—to 66 between April 2024 and April 2026, earlier than the date of 2030 suggested by the commission. It will rise by a further two years to 68 in 2046 rather than in 2050. This marks a reversal in policy. In December 2002, when the commission was established, the government explicitly ruled out a further increase in the state-pension age.

Second, the basic state pension, which has generally risen with prices since 1980, will be linked to earnings, which rise faster, in 2012—just a bit later than the commission's preferred date of 2010. This reform has been the most politically contentious part of the package: Mr Brown initially opposed it on grounds of cost. Although the commitment is subject to affordability, Mr Blair's camp believes that the chancellor will be unable to renege on it, not least because the policy enjoys strong support among Labour MPs.

Third, in an ingenious policy innovation, retirement saving will be boosted by enrolling employees into a national scheme of personal retirement accounts. The scheme falls short of compulsion for workers since they can opt out. But if they stay in, as many are expected to, their employers must contribute as well.

The lure of the short term

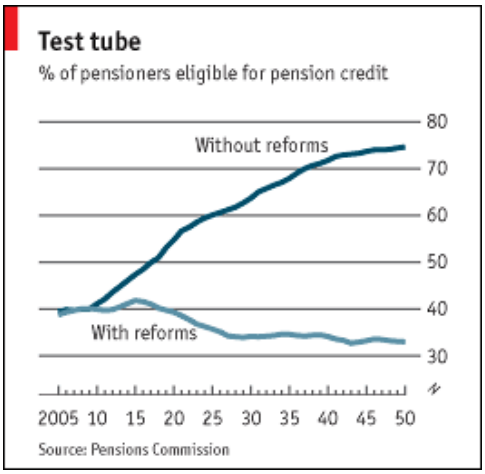
Lord Turner's success in designing a workable set of reforms holds an awkward lesson for Labour. The government is increasingly branded as incompetent, in part because of its addiction to quick-fix policies adopted for short-term political advantage (see article). This approach is particularly undesirable for pensions, where painful long-term decisions, such as raising the state-pension age, must command a national consensus. This is true around the world as governments reform their pay-as-you-go systems to take account of ageing populations, which will drive up the ratio of pensioners drawing benefit to workers paying for them. But a far-sighted strategy is especially vital in Britain because it has long relied on a partnership between the state and employers to provide adequate

pensions.

Myopic policy-making explains why Labour's record on pensions has been so harmful thus far. The damage started in Mr Brown's first budget, nine years ago, when he levied his notorious stealth tax on pension funds. This may have seemed a smart political move at the time but it weakened the finances of final-salary schemes and sapped employers' commitment to keeping them open. When pension funds sank into deficit a few years ago, companies rushed to close their schemes to new members.

Mr Brown continued to trump long-term strategy with short-term tactics through the pension credit. Hastily drawn up to buttress support among the retired before the general election in 2001 and introduced in 2003, this top-up payment undoubtedly helps poorer pensioners. But it also discourages workers from saving for their retirement because, unlike the basic state pension, it is means-tested. For every additional pound of retirement income, those eligible for the credit lose at least 40p as it is withdrawn. In effect, they are paying the top rate of income tax.

This disincentive would not matter all that much if the pension credit affected few people. But according to the commission, 40% of pensioners are already eligible for it. Without reform, that share is projected to rise to 70% within 30 years (see chart). Almost two-thirds of financial advisers fear that if they flog pensions to moderate earners they may later be accused of mis-selling.



Outsourcing policy

Labour's haphazard policy-making thus contributed to the mess that the commission had to sort out. Lord Turner's approach could hardly have been more different. He and his colleagues considered the pension system in the round, taking into account both state and private provision. They started by conducting a thorough diagnosis. Their first report, published in October 2004, made clear that on current trends and policies, pensioners would end up much poorer in relation to the rest of society by the late 2020s. To avoid this outcome, either people would have to work longer; or they would have to save more; or the state would need to spend more on pensions.

By spelling out the choices with bleak clarity, the commission prepared the ground for the sweeping changes that it recommended in its subsequent report. As Blairite ministers acknowledge, raising the state-pension age had been taboo even though it was originally set at 65 in 1925, when pensioner life expectancy was much lower. Now the public seems to accept a higher age as inevitable and the government is seeking to increase it even faster than the commission advocated.

Almost as unmentionable within Labour ranks has been Mr Brown's pet policy of directing extra help to poorer pensioners through the pension credit. By presenting clear evidence on the relentless spread of means-testing, the commission has been able to break this taboo as well. That has opened the way to restoring the earnings link to the basic state pension, another no-go area for the chancellor, but an indispensable reform if means-testing is to be arrested and saving encouraged.

Ministers have been able to present a sensible pensions plan this week because they opened up policy-making to independent scrutiny and advice. If Labour wants to govern better, it needs to outsource more. Galling though it may be for hyperactive politicians, they can often achieve more by doing less.

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The Home Office's troubles

Domestic blues

May 25th 2006
From The Economist print edition

Why the Home Office finds foreigners so hard to manage

MINISTERS normally protect their departments from attack by political opponents. A typical defence goes as follows: staff are doing a good job under difficult circumstances, things have improved immeasurably since the last lot were in government, and the department is in the midst of a big reorganisation. Which makes the appearance of John Reid, the new home secretary, before the Home Affairs Committee on May 23rd, unusual.

Mr Reid, fresh from the Ministry of Defence, turned his guns on his own department, declaring that parts of it were inadequate, dysfunctional and unfit for purpose. He singled out the "information technology, leadership, management, systems and processes" at the immigration service for criticism. That did not leave much out. He could have castigated the cleaning contractors, who, it seems, have been employing illegal immigrants to hoover the very department that is supposed to deal with them.

This frankness should buy Mr Reid some indulgences for future sins committed by the Home Office. He will probably need them. Last week a senior civil servant at the immigration service said he did not have "the faintest idea" how many illegal immigrants are in Britain. Meanwhile the number of foreign convicts still wandering the streets after their sentences ended (which is where the Home Office's present troubles began) is still uncertain. On May 24th, Mr Reid admitted that he had underestimated the number who were at large; some had been let out on bail.

Why does managing foreigners cause the Home Office so many problems? The main reason lies in the huge increase in the number coming to Britain. From the mid-1980s to the mid-1990s, about 55,000 newcomers settled each year. Since Labour came to power, the number has risen to 150,000. Their passage has been made easier by cheaper travel and a government that has dismantled some barriers to workers and their families who wish to settle in Britain. But these same changes have also benefited illegal immigrants and made them harder to police.

The government has least control over a small but politically sensitive group of immigrants. Five years ago, the number of people seeking asylum in Britain peaked and news bulletins carried images of men running into the Channel Tunnel. Panicked, Labour tightened visa requirements and toughened laws. The number of asylum-seekers duly fell. But the flow was always determined largely by foreign wars and atrocities, over which Britain has no control. Zimbabwe, Eritrea, Iran, Somalia and Afghanistan sent more than 3,000 asylum-seekers between them in the first quarter of this year, contributing to the 5% rise in the total number.

Managing the huddled masses is difficult. But the department has done some things to make it harder. It has set targets—such as one to remove more failed asylum seekers than the number who enter Britain—that have led to corners being cut elsewhere. And it has produced reams of new legislation that have distracted civil servants. Mr Reid should not add any more while he rehabilitates his department.

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Money laundering

In a spin

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Britain wants to tackle money laundering. Good luck

THE Serious Organised Crime Agency, Britain's newborn answer to the FBI, has an unusual way of working out if it is winning the fight against crime. Rather than measuring outputs, it watches markets. So instead of touting a big drug seizure, or crowing when it puts a kingpin behind bars, it tracks the street price of heroin. A soaring price, reflecting greater risks, is good news; a steadily falling price (which has been the rule during the past decade) is bad. By this measure, how is the struggle to separate criminals from their ill-gotten gains going?

Sadly, not well. The best way of tracking the money-laundering market is to focus on those people who do nothing but turn criminal proceeds into innocent-seeming cash. The going rate for cleaning, say, drug money so it can be spent on houses and fast cars without attracting suspicion is no more than 5-10%, according to Sir Stephen Lander, chairman of the Serious Organised Crime Agency. “And it's likely that we are catching the duffers,” he admits. The slicker operators may well charge less.

This is striking, and sobering, because Britain has some of the world's toughest laws against money laundering. Banks, solicitors, accountants and casinos, among others, must file “suspicious activity reports” whenever a customer does something fishy. Last year, they sent in 195,000—up from 20,000 six years ago and more, per head of population, than almost every other country. British prosecutors have a relatively easy time seizing criminal assets, when they find them.

So what's the problem? Partly the sheer volume of reports. Many police forces are so overwhelmed by accounts of dodgy dealings that they barely know what to do with them, beyond obvious things like checking if somebody they have just collared for drug-trafficking recently tried to send a lot of money to Colombia. Suspicious activity reports could be used to spot new methods of laundering money and assemble a picture of a criminal network. But this work has barely begun, partly because, just as soon as coppers acquire financial expertise, they are often hired away by private firms.

Another problem has to do with the meaning of the word “suspicious”. The Serious Organised Crime Agency has not told banks, solicitors and casinos what funny business they should look out for. And, unlike in America, there is no minimum threshold for reporting—so, in principle, the failure to report a penny deposit could mean a fine. So far, British regulators have not been so heavy-handed, but many companies are jumpy nonetheless. A report by KPMG, an accounting firm, uncovered some dubious reasons for reporting customers to the authorities. “I didn't like his attitude” was one.

Smaller outfits often err in the opposite direction. David Manley, of the City of London police, says criminal cash is probably often moved by means of pre-paid debit cards, money-transfer agencies and Islamic remittance channels known as *hawalas*. Convenient ways of sending money home have mushroomed along with London's immigrant population. And what is convenient for ordinary people also tends to be convenient for money-launderers.

The final reason London has a problem with money laundering is connected to its good reputation. Carolina Garces, of Kroll, a private security company, says Britain is not a good place to set up fake bank accounts or bogus companies: the rules are too strict. But thanks to the City's size, diversity and reputation for probity, it is a good place to move money once it has been separated from its origins. A successful drive against money laundering may, ironically, only increase its appeal.

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Politics

Tory-entalism

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David Cameron's eastern inspiration

MOST ideas borrowed by British politicians blow in from the west. Labour became New Labour under the influence of Bill Clinton's new Democrats, and the Conservatives have long tried to steal vote-winning Republican clothes. Borrowings from the east are unusual, and take longer to travel. This week, David Cameron, the Conservative leader, paraphrased a remark made back in the 1970s by King Jigme Singye Wangchuk of Bhutan, that Gross National Happiness is more important than Gross National Product. "It's time we admitted that there's more to life than money", Mr Cameron told his audience. "And it's time we focussed not just on GDP, but on GWB—General Well-Being."

The Tories hope Mr Cameron's musings will appeal to two groups that they need to court: affluent voters—who used overwhelmingly to support the party—and women, who, until last year, voted Conservative more reliably than did men. Against those who say he should stop all this piffle and come up with proper policy ideas, Mr Cameron can hold up opinion polls. An ICM poll for the *Guardian* on May 24th gave his party a lead over Labour on health and education, something that no quantity of Conservative policies could achieve before Mr Cameron became leader.

But is it wise for politicians to fret about happiness? Economists who study it reckon that once someone earns more than $20,000 a year, extra money brings little more than a brief smile (this is called "hedonic adaptation"). They also think that an unequal division of wealth, which Conservative politicians tend to regard as no bad thing, correlates with increased gloom. Andrew Oswald, an economist at Warwick University, tested this idea by offering people the chance to part with some of their own money in exchange for an opportunity to burn a greater quantity of someone else's. A majority chose to do so.

Economists know less about what actually causes happiness, which means it is hard to come up with cheery policies. Even the Centre for Bhutan Studies sometimes worries that Gross National Happiness may be rather meaningless. Mr Cameron thinks "the Protestant work ethic" is part of the problem. But Protestant countries like Denmark and Sweden come top of European happiness leagues, while ex-communist ones, whose governments were (at least officially) the most dedicated to joy, come bottom. Perhaps scrimping, striving and worrying are all part of the fun.

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Railways

Fair fares

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A misguided call for cheaper rail tickets

Get article background

MOST of the time, parliamentary committee reports embody every foreign stereotype of the British—dry, reserved and slightly dull, with only the occasional flash of sarcasm to lighten the mood. Not so those of the pugilistic transport committee. Its latest report, on rail fares, accuses the rail industry of “holding passengers to ransom” with “exorbitant” fares and an “impenetrable jungle” of ticket types.

Some of these criticisms are fair. Ticketing arrangements, especially for long-distance journeys, are Byzantine: the National Fares Manual describes over 70 ticket types within its 102 pages. Stung by public criticism, several big train companies, including Virgin, GNER and First Great Western, promise to simplify things.

The MPs are on shakier ground with their complaints about fares. They point to the amount of state money doled out to the railways—£4.4 billion this year, with £5.3 billion planned for next year—and argue that train firms should be forced to cut prices. Costly tickets, they claim, are “pricing many passengers out of the market”.

That is a tough argument to sustain at a time when more people than ever are using the railways. On some parts of the network, overcrowding, not under-use, is the biggest problem, with commuter routes into big cities such as London, Leeds and Manchester especially jammed. Fares on these routes are already capped. That's unwise, says Stephen Glaister of Imperial College. “If there is congestion in the system, then the economically correct solution is higher prices,” he says. “Otherwise you just end up with shortages and queues.” Giving railway firms greater leeway to set their own prices would let them spread demand around peak times, cutting congestion.

The only way to reduce congestion and prices together is to do things like lengthening platforms and upgrading signals, which would mean more people could be carried in the busiest areas. That would require tough decisions. A big improvement to the railway network would be expensive, and the government has shown little enthusiasm for increasing subsidies still further. Extra cash could be found by closing little-used (and heavily subsidised) rural lines, but that would be unpopular with fans of rail transport, who argue that branch lines provide a vital service to the poor and the carless.

The report occasionally hints at such dilemmas, only to shy away from discussing them in a satisfactory way. The transport committee plans a broader look at rail policy next year. Perhaps then it will do a more thorough job.

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Ports

Buccaneering

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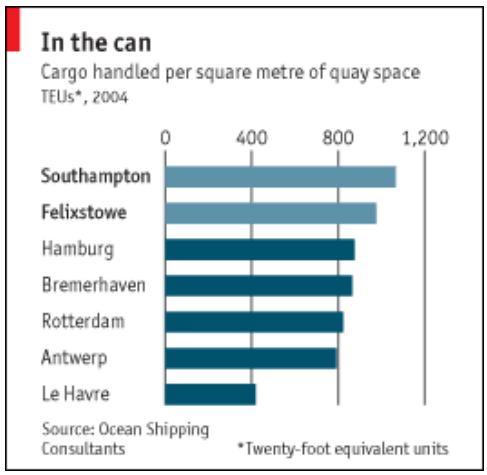
Britain's ports are bastions of free-market liberalism



ODDLY, given the importance of the sea to an island nation, Britain's ports are rarely in the news. One reason may be that people seldom come into contact with a working cargo port. More important, ports—unlike heavily regulated airports and expensively subsidised railways and roads—are mostly left to the private sector to run. But a government review, announced on May 22nd, of what little ports policy there is hints that ministers may rethink this laissez-faire approach.

The rigours of the market have served port operators well since Margaret Thatcher's government scrapped stifling labour laws and threw the industry open to competition. Isabelle Griffith of Ocean Shipping Consultants says that Britain's docks are now the most efficient in Europe (see chart).

Why fix something that is not broken? Some argue that the free market ignores important costs. The Institute of Civil Engineers, a trade body, claimed last year that leaving things to the market would mean more docks being built in rich south-east England, which already has lots of them. The engineers argue that cramming more shipping containers onto already crowded road and rail networks would lead to intolerable congestion—a social cost that private firms tend to ignore.

PD Ports runs a big dock in the north-east of England that it wants to expand. It goes even further than the engineers, saying that building new ports in poor bits of the country would bring jobs and revitalise run-down cities. Ministers seem to be taking these arguments seriously. One question in the policy review is whether the government should marry ports policy to its regional development plans.

Others have more fundamental objections. UMAST, a shipping union, argues that ports are too important to be left to fickle markets and that wiser heads should take the helm. “The whole approach to ports policy has been unco-ordinated and unstrategic,” laments a spokesman. It worries that the fashion for ever-larger container ships means subsidised European ports can out-compete privately run British harbours, which cannot afford the infrastructure needed to handle the biggest ships. And congestion at existing ports may be hurting trade. Last summer, container ships were queuing to dock at Southampton, one of Britain's biggest ports—proof, says the union, that the market is not working properly.

Fans of free markets are suspicious. “Congestion largely reflects the length of time it has taken to approve planning applications,” says Ms Griffith, pointing out that several ports want to expand. The government's record on using industrial policy to assuage social ills (which underlay, for example, its attempts to preserve British shipbuilding) does not inspire confidence. And congestion problems can be solved by requiring firms to pay for road and rail upgrades, something that the review is also considering. It would be a shame if Britain's biggest experiment with a free-market transport policy were to come to an end so soon.

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Divorce laws

Nuclear fission

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From The Economist print edition

The law lords lay down guidelines for big-money divorce settlements

IF A wife walks out on her wealthy husband after a short marriage, should the courts penalise her when dividing the spoils? If a rich husband leaves his long-suffering wife for a young bimbo, should the wife be awarded a bigger share of their joint wealth on divorce? No, said the House of Lords, Britain's highest court, this week in a firm rejection of the notion of blame being re-introduced into divorce proceedings. Straying spouses around the country breathed a sigh of relief.

In 2000, the House of Lords ruled that assets should be divided according to a “yardstick of equality”, and not simply on the basis of the claimant's—usually the wife's—financial need. Since then, judges have struggled to decide when they might depart from that broad principle of equal shares. The law lords have now tried to lay down some guidelines.

Their first case concerned Alan Miller, a fund manager with an income of over £1m a year, and his American wife, Melissa, who, on marrying, gave up her £85,000-a-year job. The union ended less than three years later when he went off with another woman. At the outset of the marriage, Mr Miller's wealth was estimated at nearly £17m. By its end, he had also acquired shares worth between £13m and £18m.

In awarding Mrs Miller a £5m lump sum last year, a lower court said that it had taken into account the husband's responsibility for the breakdown of the marriage along with the wife's “legitimate expectation” of a higher standard of living. To widespread astonishment, this was later upheld by the Court of Appeal. Under the 1973 Matrimonial Causes Act, judges are supposed to take the parties' conduct into account only if it was so egregious that it would “be inequitable to disregard it”. Adultery and desertion had never been thought to fall into that category. Did this mean the end of no-fault divorces?

No, Lord Nicholls ruled this week. Judges could not, and should not, seek to discern the truth about a marriage from the recriminations that followed a break-up. But in view of Mrs Miller's expectations and the huge increase in Mr Miller's wealth during the marriage, he nonetheless felt the size of the award was fair.

In America and most other European countries, divorce settlements take into account only those assets acquired during a marriage. But in England and Wales (though not Scotland) all assets are traditionally up for grabs. Lord Nicholls has now ruled that the “yardstick of equality” should not necessarily be applied to “non-matrimonial” assets acquired before the wedding. The ruling should cheer the likes of Sir Paul McCartney, the former Beatle, who amassed most of his estimated £800m fortune before his four-year marriage to Heather Mills, which publicly broke down last week.

The second case before the Lords concerned Kenneth and Julia McFarlane—he a senior tax partner at Deloitte Touche Tohmatsu, she a well-paid solicitor before she gave up her job to look after their three children. The marriage lasted 16 years. At their divorce, the couple agreed to share their capital assets, which were valued at £3m. But on the basis of her husband's anticipated future earnings, Mrs McFarlane demanded an extra £250,000 a year for life. The law lords decided in her favour. While agreeing that the sum far exceeded her needs, they argued that she was entitled to compensation for having given up her own career.

The rulings should help make divorce more predictable for those at the top of the earning scale—something that may also be achieved by the growing use of pre-nuptial agreements. But they will change little for ordinary folk, who will continue to scrabble for what they can get, with both sides invariably ending up worse off.

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Autistic children

A cry for help

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From The Economist print edition

Why some children with autism suffer in mainstream schools

SYBIL ELGAR, a secondary school for autistic children in Southall, west London, is a quiet place, and for good reason. Children with autism are easily overwhelmed by information and can react badly—even violently—to the wrong kind of stimulus. Sybil Elgar is designed as a “low arousal” building, without the usual eye-catching displays in the entrance hall.

The school is unusual in other ways. With just over 100 pupils, it is barely a tenth the size of the average secondary school. There are two members of staff to every five children. Some pupils have screens around their desks to reduce external stimuli. The children travel between classrooms, as they would in an ordinary secondary school—but do so in small groups, led by an adult.

About 90,000 pupils suffer from autism, but there are just 7,500 places in specialist schools. Gillian Zettle, the deputy principal of Sybil Elgar, says not all autistic pupils can cope in normal state schools. “Some can't even be with more than one person. The average secondary school would be a living nightmare for many of our children.”

Many parents agree. The National Autistic Society (NAS) recently asked more than 1,000 parents about their autistic children's educational experiences. Two-fifths had been bullied at school, about double the rate of their non-disabled peers. Some parents said their children were so unhappy that they had harmed themselves and talked of suicide. One in five children had been suspended or expelled, often more than once.

In 2002 Tony Blair's government pledged that most children with disabilities would be educated in mainstream schools. That was mostly to avoid stigmatising them, but cost may also have played a part in the decision. According to the NAS, it costs £30,000 to educate an autistic child in a special secondary school, but as little as £2,600 in a mainstream school.

Poorly-trained teachers in mainstream schools are under huge strain. Last week, the National Union of Teachers complained that schools were struggling to cope with children with a vast range of disabilities. Not surprisingly, pupils with severe behavioural and medical problems were the toughest.

The government, it seems, is now rowing back on its earlier policy. In recent evidence to the parliamentary committee on education, civil servants said they wanted to provide “a flexible continuum of provision” rather than insisting on inclusion. In June, the committee is expected to publish a critical report on a policy that once seemed laudable and benign.

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Bagehot

The hopeful interventionist

May 25th 2006
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The essential characteristic of Tony Blair's foreign policy is optimism

IT WAS inevitable that Tony Blair's meeting with George Bush on May 25th and his speech on foreign policy at Georgetown University the next day would be seen as a futile attempt to deflect attention from troubles closer to home (as in Home Office). More like out of the frying pan and into the fire.

Nothing has blighted the latter stages of Mr Blair's premiership more than the incessantly bloody aftermath of the Iraq war, and nothing is more likely to irritate British voters than the sight of Mr Blair grandstanding with Mr Bush. The prevailing orthodoxy, in the words of the late Robin Cook, is that "the invasion of Iraq has been the biggest blunder in British foreign and security policy in the half-century since Suez". Whatever else Mr Blair might be accused of, his trip to Washington is not escapism.

Talk about Mr Blair's concern for his legacy has become trite. But if there is one thing that concerns him above all, it is the continuation of what he describes as an activist foreign policy, one framed as much by humanitarian values as national interests, one that confronts the world's evils.

Two months ago, he gave the first of a series of three speeches arguing the case for interventionism. That speech was made on the third anniversary of the Iraq conflict—a moment, he admitted, that others would use to point out his folly. A second speech, to the Australian parliament, followed a week later. Mr Blair called for partnerships between countries that share the values of "democracy and the rule of law; also justice, the simple conviction that, given a fair go, human beings can better themselves and the world around them."

Neither speech received much attention, and those who did bother to comment mostly said that Iraq stood out like a livid sore on the face of an otherwise appealing foreign policy. Never mind Mr Blair's G8 focus on climate change and the plight of Africa, never mind the success of the humanitarian interventions in Sierra Leone and Kosovo or the removal of the Taliban. Iraq tainted everything.

The third of Mr Blair's speeches, delayed until now, was to have concentrated on the need to reform international institutions, especially the United Nations. The prime minister wants the next secretary-general to be chosen entirely on merit and given greater freedom to act—ideas not guaranteed a warm reception in the White House.

That is still one of Mr Blair's themes, but the other is an attack on his critics over Iraq, which he sees as neither an aberration nor yet a disaster, but central to the cause of liberal interventionism. Mr Blair waited until the formation of the new national unity government in Iraq—a rare piece of good news that he hopes, almost certainly in vain, will allow him a hearing.

Those hopes were further bolstered after Mr Blair's visit to Baghdad on May 22nd to meet his opposite number,

Nouri al-Maliki. Mr Blair does not deny that the new government could yet be overwhelmed by sectarian violence, but he is more positive than at any time in the last two years. With a little luck, he thinks the Iraqis could take control of all but two of the country's 18 provinces—Baghdad and Anbar—by the end of the year. Scepticism is in order until there is visible progress towards meeting the milestones that will allow British and American troop reductions. But not, Mr Blair would say, self-defeating pessimism.

It is that distinction between optimism and pessimism that, more than anything, marks out Mr Blair's approach to foreign policy from that of his detractors. Because Mr Blair optimistically believes that force can be used to achieve humanitarian ends, he is prepared to take large risks that pessimists would not.

The Kosovo campaign in 1999, hobbled by Bill Clinton's refusal to deploy ground troops, could easily have failed and led to the destruction of NATO had the Serbs not pulled back in the nick of time. A year later, there was no shortage of warnings that, in attempting to protect the people of Sierra Leone from hand-lopping rebel gangs, British forces would be sucked into a heart of darkness. Both were risky endeavours.

There is a fine line between optimism and wishful thinking and there's no doubt that in Iraq the latter has led to some terrible mistakes. However, even that may be preferable to the kind of conservative pessimism that allowed a British Tory government to stand idly by while Serbia set about the ethnic cleansing of Bosnia. The two foreign secretaries who were the architects of that shameful policy, Lord (Douglas) Hurd and Sir Malcolm Rifkind, have taken every opportunity to castigate Mr Blair for his recklessness and naivety over Iraq. The pernicious effect of this doctrine of not-so-benign inactivity, is, as Mr Blair says, “to see each setback in Iraq or Afghanistan, each revolting terrorist barbarity, each reverse for the forces of democracy or advance for the forces of tyranny as merely an illustration of the foolishness of our ever being there.”

Carry on intervening

Of more immediate interest than how history will judge the results of Mr Blair's activism is whether British foreign policy will revert to its “realist” ways after he has gone. Perhaps surprisingly, it may not. Gordon Brown is by nature more cautious than Mr Blair, but he too has an evangelical streak and believes that policy should follow principle. As for the Tories, although David Cameron went a little wobbly on Iraq when working for the even wobblier Michael Howard, he has since appointed gung-ho interventionists, such as his shadow foreign secretary, William Hague, to key positions.

Much will depend on who comes after Mr Bush—Mr Blair has always recognised that it is difficult to do much good in the world without a powerful and engaged American partner. But for all the political grief that Iraq has brought him, this is one part of Mr Blair's legacy that may be rather more enduring than he fears.

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Russian oil

Going twice

May 25th 2006 | MOSCOW AND MURMANSK
From The Economist print edition

Fancy a piece of appropriated property? Then give Vladimir Putin a call

AFP

Get article background

CAPTAIN IGOR BELOV is proud of the enormous engines of his oil tanker, the *Belokamenka*—even if they are purely ornamental. The *Belokamenka* is moored near Murmansk in the Arctic Circle, among Russia's nuclear ice-breakers, in a bay kept ice-free by the Gulf Stream. In the ship's bar hangs an obligatory portrait of Vladimir Putin, Russia's president, staring moodily out to sea. The ship has been converted into a floating oil terminal for Rosneft, a state-owned company that is planning an initial public offering in London and Russia. The listing was originally billed as the biggest-ever; but like Captain Belov's engines, it has begun to look less impressive than it first seemed.

The listing is scheduled for July—by pure coincidence (says Rosneft), the month when Mr Putin will be hosting other world leaders at the G8 summit in St Petersburg. On the face of it, the sale is a tempting proposition. Rosneft has grown into Russia's second-biggest oil producer, and says it will be the biggest by 2010. It has bigger oil reserves than Exxon. Last year, according to accounts published this week, the company's net profits were almost five times higher than in 2004.

There are, however, a few complications—some particular to Rosneft, others that reflect broader concerns about Russian energy. Perhaps the biggest hitch is that a big chunk of Rosneft has already been privatised once.

Around 70% of the company's output comes from a subsidiary called Yuganskneftegaz. Until December 2004, Yugansk was owned by Yukos; most of it was then bought in a forced and rigged sale by a fictitious company, which was itself immediately sold to Rosneft. That transformed Rosneft from a middling to a major oil firm. When its prospectus is published, probably next month, it will supposedly shed light on how the $9.4 billion deal was financed: some murky combination of friendly state banks and Chinese money is likely. (Chinese and Indian oil firms have been sniffing around Russian oil assets, and may be offered a stake in Rosneft; western oil majors are also interested.)

Moral qualms among potential investors and, more plausibly, concern among them about litigation by Yukos shareholders were thought by some to explain why the size of the intended listing has shrunk, from the $20 billion once envisaged to around $9 billion, or over 10% of the company. The real explanation, says Peter O'Brien, a Rosneft vice-president, is that the company's finances have improved with the rising oil price, greater production and a falling cost of borrowing.

If the price is right, demand among investors will probably be strong, even if some of them have already bought the same assets before, when they belonged to Yukos. Some will be betting that this time state control will shelter

their investment from predation, as well as securing access to new production licences and generosity from the tax authorities: the tax claims against Yugansk have been magically reduced by the courts by $3.9 billion since Rosneft bought it. Alongside these tacit advantages, Rosneft is cultivating an image of private-sector efficiency. It brought in Mr O'Brien, a plausible American, as part of a pre-listing spruce-up, and has hired some Yukos managers who are not in prison or exile. A bid to recruit Donald Evans, formerly America's commerce secretary, failed, but other independent directors are promised.

Not everyone is convinced by the makeover. One long-term observer describes Sergei Bogdanchikov, Rosneft's president, as “a mid-ranking bureaucrat who through political good fortune has found himself in charge of one of the world's biggest energy companies”. Shareholders in some Rosneft subsidiaries are also squealing about the valuations of their companies made as part of a consolidation ahead of the listing. Rosneft insists the valuations are fair, and denies other allegations that it stripped profits from the subsidiaries. Ivan Mazalov of Prosperity Capital Management, which owns shares in a subsidiary, says that although his firm might still subscribe, “we won't have any illusions about who we are dealing with.”

For all its advantages, says Vladimir Milov of the Institute of Energy Policy, state control can also mean “irrational behaviour and decisions.” A new report from the OECD details how recent growth in Russian oil production and exports (and thus in the economy as a whole) has been led by private firms. State-run companies have had higher costs and lower productivity. Nevertheless, Yugansk and Sibneft, another once-private oil firm that was last year bought by Gazprom, have been brought back under state control. Overall production has now flattened and may soon decline.

Rosneft whispers that, unlike Gazprom, it operates in a competitive market and says its managers act independently. But, like other Russian energy companies, it works within a strategic framework set by the government. For all the recent rows with Ukraine and the Europeans over gas supplies—revisited this week at an EU-Russia summit—the biggest problem with Russian energy policy is not confrontation, but paralysis. The G8 jamboree was supposed to illustrate the renewed clout that Russia's energy wealth has brought. Along with the Rosneft listing, supporting attractions were supposed to include the announcement of foreign partners for Gazprom's huge Shtokman gas project in the Barents Sea and a new law clarifying the rules for foreign participation in the energy industry. But Shtokman has become entangled in wrangling over Russia's entry to the World Trade Organisation and the new law has been postponed. And on May 25th the resources ministry endorsed the idea that Russia might want to take control of the giant Sakhalin projects from Royal Dutch Shell and Exxon Mobil.

One result of this paralysis is an oil-export bottleneck. Oil and gas in the ground are all very well; getting them to market is another matter. Pipelines are full, and the shipping routes they lead to are congested. Mr Putin recently intervened to move the route of a new pipeline to Asia away from Lake Baikal, a world heritage site in Siberia—the joke later was that he moved the lake, not the pipeline. But the project, like others, has been long-delayed, leading companies to pursue more expensive methods such as rail. The *Belokamenka*, which handles 10% of Rosneft's oil exports, is a good example: the oil reaches its Arctic mooring (and thence Europe and occasionally America) by an elaborate combination of trains, pipeline and tankers.

Investing in Rosneft also carries a risk that is unlikely to be covered in the prospectus. The listing was dreamt up as a convoluted way of paying back a big loan used to finance an increase in the state's stake in Gazprom. The state was originally supposed to raise its stake by merging Gazprom and Rosneft, but the deal collapsed, reportedly because of resistance from, among others, Igor Sechin, Rosneft's chairman and a Kremlin aide, regarded by many as the architect of the assault on Yukos. Mr Sechin is close to Mr Putin; but he has enemies, and Mr Putin is due to step down in 2008.

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PC politics

Classify this

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The American government shuns computers from a Chinese-owned firm

COMPUTERS are the epitome of globalisation, with components, whether electrical or intellectual, that come from around the world. They are commodities: regardless of the brand emblazoned on the plastic shell, the innards are essentially the same. Most of the parts come from Asia, and increasingly, from China. This has left some American politicians looking at their screens with increasing suspicion.

On May 18th America's State Department said it would not use 16,000 computers it recently bought from Lenovo, a Chinese firm, for sensitive “classified” work. Instead, the PCs will be used for more prosaic matters—many State Department staff have several computers on their desks for different levels of security, from surfing the web to reading diplomatic cables. Moreover, the department said it was “initiating changes in its procurement process in light of the changing ownership of IT equipment providers.”

These actions are a response to claims by some American policymakers that Lenovo's Chinese ownership makes the firm's computers a security risk. The Chinese Academy of Sciences, technically a part of the government, indirectly owns around 27% of Lenovo. Yet the firm is as global as its products. Last year it paid $1.25 billion for IBM's desktop-computer business. The State Department's PCs were assembled in former IBM plants in Mexico and North Carolina, following America's strict procurement standards. IBM still holds a 13% stake and has two non-voting board seats. Three American private-equity firms last year acquired roughly 12% of the firm and appoint three of its directors. Lenovo is based in New York, has an American chief executive and is publicly traded on the Hong Kong stock exchange.

Under these circumstances, the semi-ban on Lenovo computers seems a little paranoid. But American politicians know all too well that security concerns about imported technology are sometimes justified. In the 1980s America let the USSR “secretly” buy banned technologies—but only after it had sabotaged them so that they failed to work properly. And in 2001 a Boeing plane built for China's then-president Jiang Zemin was rejected after it was found to be stuffed with surveillance devices.

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Intel

Not paranoid enough

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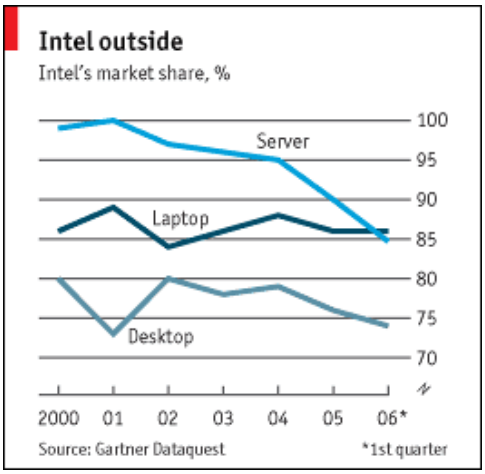
Can the world's biggest chipmaker reverse its foundering fortunes?

THE brains inside computers, called microprocessors, are measured in nanometres and their speeds in the billionths of a second. But it takes years for the companies that make the silicon chips to overhaul their strategies. Since 2003, Intel has struggled while its far smaller rival, Advanced Micro Devices (AMD), has gone from strength to strength.

The next six months may show whether Intel can reassert its dominance. The question is whether Intel's technology will leap ahead of AMD'S when it releases new chips later this year for laptops, desktop computers and big computer servers. For AMD, the test will be whether it can offer innovative products without succumbing to the supply problems that have dogged it in the past. On June 1st AMD will reveal its closely watched "roadmap" for new products, shedding light on how it plans to compete.



In recent years AMD's chips have been faster, used less power, generated less heat and cost less than Intel's. As a result, Intel has suffered. The company's profits are sinking and revenue is forecast to decline by 3% this year. Logistical problems have cost it sales and added to its inventory. Intel's market share has sunk in most categories of computers, according to Gartner, a market-research firm (see chart). Dell, the biggest PC-maker, facing its own woes, recently abandoned its Intel-only strategy in favour of AMD chips in a niche category of computer servers—a symbolic blow. Intel's share price has dropped around a third in the past year.

As a result of its flagging fortunes, Intel said in April that it would slash $1 billion in costs as part of a broader restructuring to be worked out later this year. Since Paul Otellini took over as chief executive a year ago this month —the first boss from sales, not engineering—the company has been chastised for placing marketing ahead of technology. Indeed, in recent months the firm has been preoccupied with redesigning its corporate logo and dreaming up brand names for the bundles of chips it supplies to different markets: Centrino for laptops, vPro for corporate desktops and Viiv for media PCs.

However, Intel's main problem is that companies take a long time to switch strategies in the chip business. Once its new products are available in large numbers, the firm expects to recapture its lost market share, says Eric Kim, its head of marketing. Intel has already started shipping chips with features only 65 nanometres wide (AMD remains at 90nm) and plans to produce 45nm chips in 2008. Smaller chips usually mean faster speeds, lower power consumption and, importantly, better margins—since more chips can be sliced from a single slab of silicon.

Moreover, Intel has copied AMD by starting to sell its new chips on the basis of energy efficiency. That matters: the huge computer centres used by companies and websites require enormous amounts of electricity. Reducing the power consumption of a microprocessor by one watt reduces the consumption of a data centre by three watts, since it means less energy is required for cooling.

EPA

Otellini, the marketing man

Whether AMD can match Intel's technical pace is an open question. Hector Ruiz, AMD's boss, says the firm's seasoned management team and engineering talent have proved their worth. AMD is betting that by devoting itself to microprocessors—and relying on others to supply the remaining chips—it can compete against Intel by giving PC-makers more choice. “We have worked hard with our more open approach to become critical to our customers' long-term success, which by definition fuels our momentum,” Mr Ruiz says.

Unfortunately, if both companies succeed, the very strategy that has worked well in the industry may be disrupted. Intel has famously relied on branding to woo customers. But with an alternative, customers may pay more attention to the power under the hood than the sticker on the top. “They wouldn't care if there were a hamster and a treadmill in there,” says Jim Turley, the founder of Silicon Insider, a technology-analysis firm. Many customers, he says, have now “tasted the AMD apple, and they like it.”

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Car retailing

Death of the salesman

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Online car sales are taking off

IF THERE was ever an industry vulnerable to technological change, it would have to be selling cars in America. For decades a franchise network made up of thousands of dealers has peddled ordinary cars as though they were exotic goods in a Moroccan souk. Each dealer seems to have his own opaque pricing scheme, consumers have to endure endless haggling and the financing is murky at best. Small wonder, then, that the shifty car salesman has became such a stereotype.

A decade ago a few brave souls tried to use the emerging power of the internet to modernise this fragmented and frustrating business. Scott Painter, a Californian entrepreneur, founded CarsDirect in an attempt to sell vehicles direct to consumers online. But the business failed to work as he had hoped, and he eventually left the company. Jac Nasser, when he was still running Ford, also tried to bypass his own dealers and sell cars on the internet. He even sued, but the Austin District Court issued a curious ruling against Ford in 2000, stating that: “The plaintiff is prohibited from selling motor vehicles to consumers by mail, phone calls, leafleting, skywriting, or drum signals, as well as on a plane, on a train, in a house, or with a mouse.”

Hope springs eternal, at least where the internet is concerned. This week Mr Painter is launching Zag, his latest attempt to modernise automobile retailing using the internet. His first big customer is Capital One, a financial giant that is one of the country's biggest providers of car loans. Meanwhile, AutoNation, the country's largest car retailer (with over 300 dealerships), is launching Smart Choice, its own internet marketing-scheme, in June. And rumours are swirling that Amazon and Chase bank are (separately) about to enter the online car-sales business.

So is the time finally ripe? Glenn Mercer of McKinsey, a consultancy, believes that internet sales efforts, even fixed-price schemes, will not save customers much money because the internet firms by law cannot buy cars directly from manufacturers; they must get them from dealers. Brian Reed of Capital One retorts: “It's true, we may not offer the lowest price—but we will offer a fair price with a lot less pain.”

But the pain is not always so easy to escape. Visit many online sites to research a car, and they will sell your name immediately to local dealerships which will then harass you in the old-fashioned way. That is hardly a revolution, as Mr Painter acknowledges: “Our original vision for CarsDirect was that we would wipe out the dealer. Nope: it ended up as a lead-generation service.”

Still, there are reasons to think that conditions may finally be favouring online sales. J.D. Power and Associates, a research firm, reckons that two-thirds of new car customers use the internet for research, up from a quarter in 1998. AutoNation reports that car sales originating on the internet have increased from 14% of its total in 2002 to about a quarter last year.

The rise of credit unions and affinity groups like the American Automobile Association and Costco (a cut-price retailer) is also modernising car retailing. In the past, such groups would refer their members to certain dealers, in return for cash and the promise of a lower price. The members' discount often failed to materialise, in reality, but the groups had no way to police what dealers did. But with the latest inventory-monitoring software integrated into portals such as Capital One's new DriveOne programme, clubs can now guarantee a fixed price for a car chosen by a member and check that the dealer sells it at the promised price.

Because price transparency is squeezing margins, argues Sid DeBoer of Lithia, one of the country's biggest car retailers, dealers are now desperate to find ways that the internet can help them. He is convinced that online sales of new cars will soar from nothing to a quarter of Lithia's total within a decade. Consolidation among dealers, led by Lithia and AutoNation, also supports a move away from haggling to fixed pricing, since bigger firms are in a much better position to enforce price discipline.

So will all this mean the death of the salesman? Do not count on it says Mike Jackson, the boss of AutoNation. His firm has already cut in half the time taken to buy a car, and it wants to cut it in half again by automating various bits of paperwork. But Mr Jackson is convinced that consumers will always want to kick the tyres on their new car, before they sign on the dotted line: “We'll put the distasteful parts online, and leave the fun part—it's like going to a candy store.”

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Bertelsmann

All in the family

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Bertelsmann saves itself from a public listing

HOW much are you prepared to pay for family values? For Bertelsmann, the answer is €4.5 billion ($5.75 billion). That is the amount that the family-controlled media group this week agreed to pay Groupe Bruxelles Lambert (GBL) to avoid a public listing of 25.1% of its shares. For this luxury, Bertelsmann has more than doubled its existing debt.

Bertelsmann has been in family hands ever since Carl Bertelsmann founded it in 1835. Reinhard Mohn, who built it into a global media company after the second world war, is his great-great-grandson. His wife, Liz, once a telephonist at the firm, chairs the management company which has majority control of the group. Ms Mohn is a firm believer in the culture of Bertelsmann as a family firm. It was never a secret that she abhorred the idea of going public. The problem was that, in 2001, GBL took a 25.1% stake in Bertelsmann in exchange for a 29.9% share in the RTL Group, a broadcasting company, to give Bertelsmann a controlling 67% of RTL.

The deal gave GBL the option to list its stake in Bertelsmann publicly after five years. GBL, the investment vehicle of Albert Frère, a Belgian entrepreneur, and the Desmarais family of Canada, had said in January that it intended to opt for the listing. The fact that Bertelsmann was clearly desperate to avoid this fate strengthened Mr Frère's hand. He had been rumoured to be hoping for €5 billion; Bertelsmann unofficially valued the stake at somewhere between €3.3 billion and €3.6 billion.

The media company is probably overpaying by around €500m. However, it avoids the scrutiny of stock analysts and the activism of hedge funds. Not that it avoids disclosure completely: it produces rudimentary quarterly results; it has one listed company, RTL Group, with 10.2% of its shares listed in Brussels and Luxembourg. It also has €516m of profit-participation certificates, which are share-like although they have no voting rights, and €1.4 billion of publicly traded bonds.

Both Moody's and Standard & Poor's put the group on a negative credit watch this week, but indicated that a share buyback would not necessarily push the firm's credit rating below investment grade.

Bertelsmann plans to reduce its new debt by selling BMG Music Publishing which might fetch up to €1.7 billion. The rest will come out of cashflow from expected bumper results this year. Gunter Thielen, Bertelsmann's chief executive, said the group is running better than at any time in its history. For that reason it was a good time to buy back the GBL stake—before it got even more expensive. Bertelsmann can continue its conservative dividend policy, and GBL has avoided the price risk of a share-offering some time next year, which looks higher now than it did a month ago.

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Internet telephony

Vonage unwanted

May 25th 2006 | SAN FRANCISCO
From The Economist print edition

An embarrassing share-offering in a promising market

IN 2003 Jeffrey Citron, a former broker, paid $22.5m in penalties to settle allegations of fraud and agreed never to work in the securities industry again. He then turned his attention to his next big thing—making phone calls over the internet. He launched Vonage, a company in New Jersey that has since become almost synonymous in America with the term VOIP (for “voice over internet protocol”). Spending oodles on marketing, Mr Citron has persuaded 1.6m Americans to ditch their land-line telephone company. In the American VOIP industry—which has 5.5m subscribers now, but should have 24m by 2010, according to TeleGeography, a research firm—Vonage is the leader.

That did not count for much on May 24th, when Vonage made the worst stockmarket debut by an American technology firm in two years, offering new shares worth $531m in total, which dropped 13% by day's end. There had been signs of desperation in the preceding weeks—such as a plea to customers to take up 13.5% of the new shares—but a belly flop of these proportions was surprising. Is VOIP over-hyped?

Actually, making calls over the internet is proving more popular than even geeks once predicted. Unfortunately for Vonage, however, this has meant that established firms are fighting much harder than expected to move into VOIP themselves. America's cable companies now offer cheap bundles of broadband internet access (a requirement for online telephony, but one that Vonage does not offer), VOIP and television. The telecoms incumbents are responding with similar bundles—ie, broadband, VOIP and IPTV, or “internet-protocol television”.

And there is even stronger competition. Vonage and the giants are in fact offering a compromised form of internet calling. Customers get a clunky box that plugs into a normal telephone at one end and a broadband modem at the other; calls are cheaper, but not free. Pure internet calling, by contrast, involves software that lets computers talk to other computers completely free, has superior voice quality and offers lots of other fun, like instant-messaging. The best-known example is Skype, based in Estonia, though Google, Yahoo!, AOL and Microsoft offer similar services.

Which may explain why Mr Citron was in a hurry. Skype sold itself to eBay for $2.6 billion last year. This month Skype offered its users free calls from their computers to ordinary phones in North America, a snub to Vonage. Mr Citron, who could not find a corporate buyer, forged ahead with an IPO, setting the price at $17 a share, which valued Vonage at a sliver more than Skype. The market did not agree.

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French business and politics

Muddying the waters

May 25th 2006 | PARIS
From The Economist print edition

French bosses wring their hands at the state of their government

FOR weeks the French chattering classes have been obsessed by the identity of *le corbeau* (the crow). Now the secret is out. The anonymous informer, who had tried to link important politicians including Nicholas Sarkozy, the leader of the conservative UMP party, to secret bank accounts in Luxembourg was Jean-Louis Gergorin. Mr Gergorin has now been sacked from EADS, the defence firm where he was a senior executive.

That the former EADS executive was a close confidant of Dominique de Villepin, the prime minister and Mr Sarkozy's arch political rival, has raised the political stakes in the Clearstream affair. It has also highlighted the longstanding and unhealthy connections between the top levels of French business and the French state. This tradition has fed an incestuous and conspiratorial approach to both politics and business. Mr Gergorin himself is partial to conspiracy theories: after Jean-Luc Lagardère, his boss at EADS, died in 2003, he became convinced that his mentor had been killed by the Russian mafia.

But the Clearstream affair shows signs of provoking a backlash in the French business world against the old way of doing things. “We are worried about France's image as a credible, stable, trustworthy country,” warns Laurence Parisot, head of MEDEF, the employers' lobby. “All this is deeply depressing,” sighs Bruno Lafont, boss of Lafarge, one of the world's biggest makers of building materials. Henri de Castries, boss of AXA, an insurance giant, and a former university classmate of Mr de Villepin, is scathing. “We live in a great country that is disastrously governed,” he declares.

French bosses have been complaining for at least a decade. They deplore the rigidity of the labour market and the constraints of the 35-hour working week. They moan about high taxes and the crushing burden of bureaucracy. And they beef that senior politicians and civil servants neither know, nor care, about business.

But in the past year their unhappiness has mounted, as the social and political climate has worsened—following widespread rioting and the French government's defeat in an EU referendum last May. Mr de Villepin's government, although nominally conservative, is increasingly embracing the rhetoric of the anti-globalising left. It has introduced a series of protectionist measures, such as “poison pill” defences to ward off hostile bids for French firms.

Such business-friendly reforms as have been carried out during the Chirac years have been cosmetic. Successive prime ministers have tinkered with tax rates and the 35-hour week. But when the government did attempt a far-reaching reform of the labour market earlier this year, it backed down after nine weeks of student and union-led protests across the country.

This month Mr de Villepin attempted to regain some ground, by announcing a series of initiatives to help 2,000 so-called gazelles, small, high-growth companies with five to 250 employees. And on May 22nd he proposed 40 measures—many designed to cut red tape—to make France a more attractive place for business. The country's image among international businessmen is getting steadily worse. In a recently published annual report on the competitiveness of nations by the Institute for Management Development (IMD) in Lausanne, France's ranking fell to 35th from 30th in 2004—well behind Germany (24th) and Britain (21st).

So how can the bosses improve matters? They have wavered between shouting and pleading. After a big defeat for employers—the Socialist government's decision to trim the working week from 39 hours to 35 with no loss of pay—Ernest-Antoine Seillière, the previous head of the employers association, became increasingly outspoken in his demands for reform. But some of his colleagues feared he was marginalising business and Ms Parisot came to office in 2005, arguing for a more consensual approach. However, she too seems to be becoming exasperated. In a speech at the beginning of the year Ms Parisot criticised Mr Chirac for the “incomprehensible paradoxes” of his policies. On the one hand, she said, he is renouncing the concept of the welfare state, but on the other, he is trying to replace it with the “welfare company”, an enterprise that is ruinously generous to its employees.

In truth, the problems of French business run deeper than the inadequacies of the Chirac government. Opinion polls show that the French are much more suspicious of capitalism than are the citizens of almost any other developed nation—a sentiment that seems to be stoked up by the educational system and inflamed by politicians,

80% of whom come from the public sector.

Many French businessmen are now pinning their hopes on the prospect that Mr Sarkozy will win the presidency next year, and that he will have the courage to push through economic reforms. It is true that Mr Sarkozy has called for a “rupture” with the practices of the past, and has even risked describing himself as a “liberal”. Yet as finance minister he revealed distinctly illiberal instincts—intervening to save jobs at Alstom, an engineering company, and to press Sanofi and Aventis, two pharmaceutical firms, to merge and create a national champion. A consummate populist, he will always be tempted to play to the anti-capitalist gallery.

Although Mr Sarkozy may turn out to have been the victim of close ties between the prime minister's office and French business, he hardly seems likely to eschew the traditionally close relations between France's boardrooms and its ministerial offices. Those who hope the Clearstream affair will mark a new beginning for French business are likely to be disappointed.

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Face value

More, more, more

May 25th 2006
From The Economist print edition

Nokia's new chief wants to lead the mobile-phone giant into new markets

AP

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THE story of Nokia's transformation from an obscure Finnish conglomerate into the world's largest maker of mobile phones is an object lesson in the virtue of specialisation. A sprawling business that once made everything from tyres to toilet paper to televisions, Nokia switched its focus to mobile phones in the 1990s under its visionary chief executive, Jorma Ollila. Under his leadership, the company overtook Motorola, its American rival, to become the world's largest handset-maker—a position it has clung to ever since. As Mr Ollila steps down on June 1st, however, he hands his successor, Olli-Pekka Kallasvuo, the difficult task of leading Nokia into new markets as the distinction between mobile phones and other consumer-electronics devices becomes increasingly blurred.

Mr Kallasvuo, a member of the tight-knit group that has run Nokia since the early 1990s, will inherit a company in excellent shape. Nokia has a renewed spring in its step, having recovered from a stumble in early 2004, when a lacklustre product line-up caused its market share to drop below 30% for the first time in years. A pioneer in design, Nokia lost its edge when it failed to anticipate the popularity of slim “clam-shell” phones. It fought back, first by cutting prices and then by revamping its designs. Its market share is now at around 35%. The mood at the company is buoyant: in addition to the satisfaction of having bounced back so convincingly, Nokia's strong financial performance meant big bonuses for many employees. “If you look at the portfolio, I think we have regained leadership,” says Mr Kallasvuo. “The foundation is there, so that we can concentrate on what is next.”

And what is that? As the leader in mobile phones, Nokia now has to take a broader view of the market, he believes. “Comparison with our own industry is not adequate any more,” he says. “We need to look at this in a much wider way.” The rise of the camera-phone means that Nokia now sells more cameras than anyone else does, for example, and advanced handsets often also include music-playing, video-recording and computing (including e-mail). Mr Kallasvuo does not mention names, but his drift is clear: rather than just comparing itself with rival handset-makers such as Motorola or Samsung, Nokia now considers its competitors to be Apple, Sony, Canon and other consumer-electronics firms. “The convergence of internet and media content is happening in the way everyone predicted four or five years ago,” he says. “We are more and more competing against other people, against new types of competitors. We are all converging.”

Nokia has responded by launching a range of advanced handsets, called the Nseries, which focus on specific features in addition to being phones. The N73 camera-phone, for example, is aimed at people who maintain photo blogs, and includes software for uploading images to Flickr, a popular image-sharing website. Similarly, the N91

phone doubles as an iPod-style music player with a built-in hard disk; the N92 is a mobile television; and the N93 is a video camera. Perhaps most surprising, however, is Nokia's 770 Internet Tablet, a hand-held computer that does not contain a mobile phone at all. Instead, it supports web-browsing, e-mail and voice-over-internet calls (using Google Talk software) via short-range Wi-Fi technology. “It is the best possible illustration of convergence,” says Mr Kallasvuo. It also highlights Nokia's willingness to step outside its usual market.

That sounds a pretty ambitious expansion strategy. But Mr Kallasvuo also wants more from traditional markets. Nokia may strive to emulate Apple with its most expensive phones, but the core of its business, with its efficient logistics and huge volumes, has more in common with Dell. (Of the 900m mobile phones that will be sold this year, 320m of them will be made by Nokia.) Around 70% of the industry's growth this year will come in the developing economies, and Nokia's cheapest handsets are doing well in China, India and Latin America. Some critics argue that Nokia ought to focus solely on high-margin products such as the Nseries, but Mr Kallasvuo disagrees. “With our volumes, our economies of scale, we want to be in all of these markets,” he says. Even Nokia's cheapest handsets are profitable, he points out. And if your first handset is a Nokia, you are more likely to stay with the brand when moving upmarket—“so being strong at the low end has strategic importance.”

Opportunity in complexity

One market in which Nokia could plainly do better is North America. It has been weak there, because many networks use a different wireless standard (called CDMA) rather than the GSM technology used in Europe. Nokia has devoted a lot of effort to raising its profile in North America in the past two years and has recently formed a joint venture with Sanyo of Japan to produce fancy CDMA handsets. Tellingly, Mr Kallsvuo plans to spend one week a month in America, which is important not just as a big market but also because it is where trendsetting products, such as Apple's iPod, often appear first.

The breadth of Mr Kallasvuo's ambition—more convergence, more China, more America, more everything—looks potentially overwhelming, particularly as Nokia moves into a new and fiercely competitive market—consumer electronics. Managing the complexity of converged devices is difficult, Mr Kallasvuo concedes, but it also provides scope for differentiation, “and overall that's an opportunity.” Another danger is that Nokia may alienate wireless operators, its main customers, by helping consumers get round their proprietary networks and instead supporting open, internet-based services such as Google Talk in its devices. But the rise of internet standards means the industry's old rules no longer apply. “We will need to be agnostic enough to make pragmatic decisions,” says Mr Kallasvuo. “Natural evolution is happening in the marketplace, and we need to act accordingly.”

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Financial exchanges

Battle of the bourses

May 25th 2006 | FRANKFURT, LONDON, NEW YORK AND PARIS
From The Economist print edition

Corbis

Behind the mergers of financial exchanges lies not just a quest for size and scope, but also a fight for survival

THE desire to merge has never been stronger among the world's financial exchanges. This week the bidding intensified between the Frankfurt-based Deutsche Börse and the biggest of them all, the New York Stock Exchange (NYSE), to buy Euronext, itself the product of a series of mergers that, if talks go well, may soon absorb Milan's Borsa Italiana.

At Euronext's annual shareholder meeting in Amsterdam on May 23rd, Jean-François Théodore, its chief executive, was given a rough ride before eventually winning backing for his choice of partner, the NYSE. This would create the first transatlantic exchange capable of offering equities, options and futures. Many Euronext shareholders would prefer a more local marriage with Deutsche Börse, which is even now said to be preparing to raise its bid to top the American offer of €8 billion ($10 billion) in cash and shares.

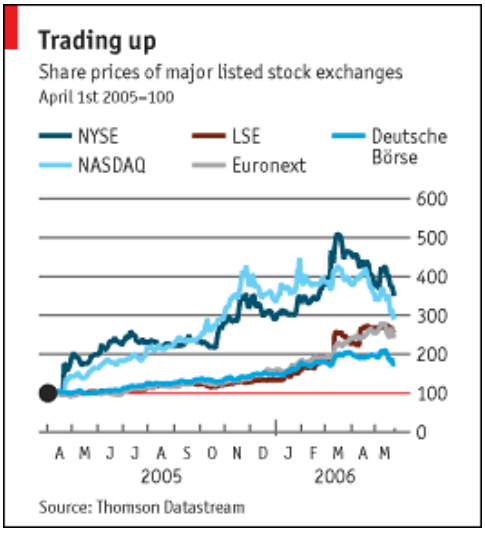
Meanwhile, the London Stock Exchange (LSE) is once again the subject of unwelcome attention. Having fended off bids from Deutsche Börse and Macquarie Bank of Australia, the exchange is now stuck with a single suitor and few choices. NASDAQ, which had its previous approach rebuffed in March, has been busy building a 25% stake in the London exchange—enough to thwart, or at least complicate, any rival bid. Nor can NASDAQ quickly tie the knot. Unless the LSE accepts its bid or receives a counter-offer, Britain's takeover rules prevent NASDAQ from either making another bid before October or increasing its stake beyond 29.9%. Still, shareholders cannot complain about the London exchange's *froideur*. Deutsche Börse said it would offer £5.30 ($10) a share, Macquarie bid £5.80 and NASDAQ offered £9.50—and would have to pay still more if it bid now.

Such rises are partly the result of speculation by increasingly powerful hedge funds. But even though share prices of the listed exchanges have come off their record highs (see chart), analysts are still hard pressed to explain why shares in Deutsche Börse, for example, are now worth about €100, up from €45 at the end of 2004.

These high valuations come at a time when the franchises held by exchanges seem ever more vulnerable. They face intensifying competition, fostered by technology that is rivalling the exchanges' traditional trading methods and by regulation that is increasingly permissive (if also still sometimes highly political). Commissions are declining fast and a growing volume of trading in financial securities of all sorts now takes place “off exchange”, inside banks or across alternative networks.

Strikingly, this picture of an industry in a corner is wildly at odds with the exchanges' declared rationale for merging. This is all about the efficiency of the infrastructure behind the world's capital markets. From the exchanges' point of view, today's transatlantic battle is the latest step in

an evolution that began in Georgian London's coffee houses and under a New York buttonwood tree.



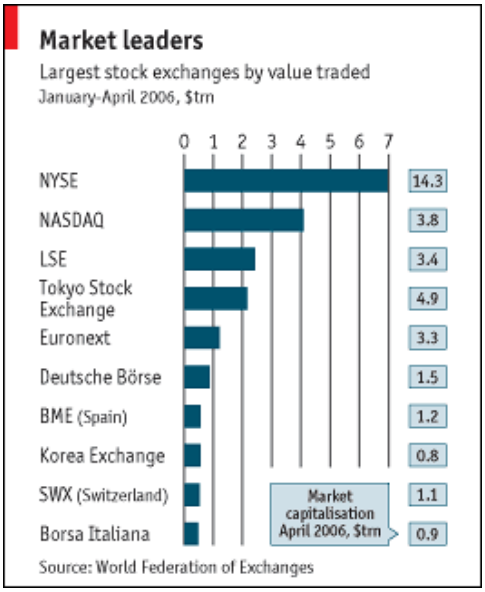
The hundreds of exchanges, usually housed in grand buildings with spacious trading floors, which grew over the centuries out of those informal gatherings, have no place in today's world of global capital flows and high-speed electronic trading. The old-style exchanges were traditionally organised as mutual trading clubs that charged outsiders commissions and others fees to gain access to their liquidity. Their members mounted a lengthy rearguard action against the forces of efficiency, which promised to benefit their customers at the expense of their own traditional sources of profit. That has now ended in a series of demutualisations. Members have voted to turn their exchanges into for-profit public companies. Now the members have cashed out, the exchange can then be run—or, increasingly, sold—to maximise the value of the business rather than to serve the narrow interests of its members (by providing such benefits as jobs for floor traders, or a privileged look at the order flow from outside investors). The three big European exchanges—LSE, Euronext and Deutsche Börse—demutualised in 2001. The NYSE listed its shares in March.

With outside shareholders now in charge, consolidation of the world's exchanges can take place relatively easily. “The dream of this mating of dinosaurs is to create a global super-exchange that is a natural monopoly,” says André Cappon of the CBM Group, a consultancy that specialises in exchanges. “Then they hope to raise prices—though, of course, no one will admit that this is their goal.”

Instead, exchange bosses prefer to dwell on the potential cost savings and economies of scale that they expect from integration. The technological demands on exchanges are growing rapidly, especially as hedge funds increasingly dominate trading—they account for about 40% of volume in America, for example. Many hedge funds use automated algorithmic trading methods that spew out vast quantities of electronic limit orders designed to exploit trading opportunities that may exist for only a fraction of a second.

Building a trading platform able to handle this order flow is expensive. But most of these costs are fixed, so big economies of scale can be gained by adding more shares or other financial products to a trading platform. This, it is argued, reinforces a natural tendency to gravitate to a single exchange, as buyers of securities typically feel that they are likely to get the best price if they can deal with as many sellers as possible and vice versa.

The European Commission foresees vast gains from consolidating exchanges within Europe. According to a commission document released on May 23rd, Europe's aggregate extra cost of trading, clearing and settlement (the “paperwork”, in pre-electronic jargon) is between €2 billion and €5 billion a year. Eliminating that would lop 7-18% off investors' costs. The commission is particularly exercised by the high cost of cross-border trading. Buying and selling shares in another European Union country can cost up to six times more than dealing at home.



On the face of it, big cost savings would flow from merging Deutsche Börse and Euronext, especially given the “spirit of true partnership” radiating from the German exchange's boss, Reto Francioni. In fact, that is a friendly-sounding way of saying that the merged exchange would be run out of Frankfurt, with Mr Francioni in charge, and the two businesses integrated as much as possible.

The silos of trading

But it is easy to pick holes in the exchanges' story. For a start, the savings assume that the promised benefits of integration can be secured—which, as in mergers of all sorts, is easier said than done. Euronext's boss, Mr Théodore, can testify to his own frustrations following the acquisition in 2002 of Liffe, the London International Financial Futures and Options Exchange.

One worry is that Deutsche Börse operates a vertically integrated trading “silo” in a way that makes it hard to identify the costs of trading, clearing and settlement. Although Deutsche Börse says it has the cheapest clearing and settlement, no one is entirely sure it is right. The fear—voiced especially loudly by Thierry Breton, the French

finance minister—is that a hidden cross-subsidy between different parts of the business may distort competition. A European directive on clearing and settlement is likely to address this worry, but not for at least three years.

American exchanges are not responsible for clearing and settlement, which is one reason why Mr Breton appears to favour the NYSE bid for Euronext—although he has not officially taken sides. But there may be other grubbier reasons behind the American preference of Mr Breton and Mr Théodore.

A nationalistic approach to business is in vogue in France, not least among its politicians. Mr Breton insists that any merger should preserve a strong share-trading operation in Paris, which must be regulated by the Autorité des Marchés Financiers, the French regulator. He also wants to maintain Euronext's “federal” corporate governance. Happily, the NYSE intends to adopt just such a federal structure, with the European arm continuing to be run out of Paris by Mr Théodore. That should also please French banks.

Indeed, national pride and self-preservation ring as clearly in the exchanges' plans as the opening bell at the NYSE. Mr Théodore's acquisition of Liffe did not deliver the promised economic benefits, but it at least prevented the LSE from buying its domestic partner, a merger that would have created a combined London exchange capable of crushing the Paris, Amsterdam and Brussels exchanges that had together formed Euronext.

Other potential mergers have fallen foul of nationalistic politics, too. A first bid for the LSE by Deutsche Börse in 2000, and the German exchange's approach in 2004 to SWX, a Swiss stock and derivatives exchange group, both collapsed. A cautious eye also has to be kept on the powerful hedge funds. A year ago activist shareholders led by a hedge fund called TCI forced out the then boss of Deutsche Börse, Werner Seifert. The fund believed his bid for the LSE was too expensive, leading one prominent German politician to describe hedge funds as “locusts”, even as other commentators praised them for introducing financial discipline into a business that had hitherto not given much thought to its shareholders' interests.

Now TCI and Atticus, another hedge fund with shares in both Deutsche Börse and Euronext, are pressing for a fusion of the two. Political pressures probably rule out any last minute embrace between Deutsche Börse and the LSE—in many ways, the natural European combination—despite rumours that the German exchange is mulling a bid for NASDAQ which would bring with it a 25% stake in its London rival.

Politics and pride also help explain why the New York exchanges want to invest in Europe. John Thain, the boss of the NYSE, is hugely ambitious. He took charge at one of the lowest points in the Big Board's history. Scandals had driven out its former boss, Richard Grasso, the self-styled “CEO of capitalism”. Mr Thain's move to the exchange was thought to owe as much to his desire to prove himself worthy of high public office by saving the NYSE as to his frustration at not getting the top job at his former employer, Goldman Sachs. He may have concluded that the American public will think more of him if the NYSE emerges from the dealmaking as one of the consolidators rather than the consolidated, regardless of whether its owners gain most from that strategy.

And although you can take the man out of the investment bank, you cannot seem to take the investment bank out of the man. Mr Thain clearly has a taste for deals. He recently merged the NYSE with Archipelago, an electronic-trading exchange partly owned by Goldman. The deal benefited the investment bank in so many different ways that some Wall Street wags joked how Mr Thain had not left the firm after all. Apparently in part to silence such critics, Mr Thain has chosen Citigroup, not Goldman, as the NYSE's adviser for the Euronext deal.

Another attraction of Euronext to the NYSE is that it caters for trading in both shares and derivatives, something the London exchange cannot offer. One way to maximise the value of a trading platform is to push more transactions through it, and although it is hard to invent new shares to trade, dreaming up new derivatives is a piece of cake.

Above all, through a European merger Mr Thain may hope to regain access to the new-listing business. This is clearly a goal of NASDAQ, too. In 2000 nine out of every ten dollars in the world's initial public offerings were raised in America. Last year nine out of every ten dollars were raised outside America—which Mr Thain bemoaned at a dinner last month with Silicon Valley luminaries. The flight of initial offerings, notably to the LSE's Alternative Investment Market, has been blamed on America's costly Sarbanes-Oxley law, introduced after the collapse of Enron.

One of the biggest fears of investors in London is that if NASDAQ buys the LSE, it will bring with it the dead hand of Sarbanes-Oxley. “Whatever happens, the regulatory domicile must stay in London. Apart from that, we have no particular prejudice who owns the exchange,” says Peter Montagnon, of the Association of British Insurers, whose members control about one-sixth of the shares on the LSE. “What makes London attractive is its regulation. One of the things we regulate well is listings.” Although regulatory arbitrage may now be its main goal, NASDAQ has a long history of overseas expansion, little of it happy—a lesson worth pondering during today's merger frenzy. In the late 1990s the exchange struggled in both Europe and Japan. (How long before the Tokyo Stock Exchange gets caught up in merger mania, too, assuming its planned flotation goes ahead?)

Thanks to regulatory arbitrage, the exchanges can gain from national regulators' determination to exercise their own market oversight. On the other hand, the exchanges' differing trading rules may limit the scope for

efficiencies. Perhaps common trading rules can be developed between regulators in America and Britain, says Benn Steil, a financial economist at the Council on Foreign Relations in New York. But America's Securities and Exchange Commission is “in an exceptionally weak negotiating position, as American investors are increasingly going abroad to invest,” he notes.

In any case, regulators seem determined to prevent a single global trading platform with natural-monopoly power, says Mr Cappon. Indeed, he doubts that such a monopoly could arise even if regulators stood back. A few hedge funds may think they can profitably monopolise the trading infrastructure, but plenty of actors in the financial markets will do all they can to stop that happening.

EPA

Making good television

The power of traditional exchanges is likely to be curbed in three ways. The first is for big financial institutions to “internalise” their trades, netting off buy and sell orders against each other without passing them through an exchange. The big Wall Street firms have lately made great efforts to internalise trading through electronic alternative-trading systems, commonly known as ATSs. It is widely expected that these will eventually be linked together directly. The old members of the NYSE, in short, will create their own membership network. This cannot be good for the NYSE, something that will surely not have eluded Mr Thain. In Europe, fears that a pending directive over markets in financial instruments will hinder such internalisation have eased.

Secondly, investors can trade “over the counter” via brokers rather than through an exchange—a business that is booming. The last curb on the big exchanges is a forthcoming wave of technological innovation, which will help America's regional exchanges, such as the Boston Equities Exchange. These only recently seemed doomed, but the Boston exchange is now being revived by Citigroup, Lehman Brothers, CSFB and others.

In America, three firms provide a particularly promising and different way to trade: POSIT, Pipeline and, above all, Liquidnet. Each offers big institutions anonymous ways to trade large blocks of shares, something that has become increasingly difficult when using an exchange in the traditional way. Liquidnet has grown in five years to 45m trades a day, and Pipeline to 20m a day in two years. The three firms now account for some 5% of daily trades in America, and will surely soon be far bigger.

Playing Monopoly

So much for the notion that liquidity and technology will inevitably make trading a natural monopoly. NASDAQ's overwhelming market share in stocks not listed on the NYSE and American Stock Exchange disappeared a decade ago. It has never returned, despite the acquisition of its largest competitor, Instinet. Up to two-thirds of transactions in British shares and perhaps 75% of German share trades now take place off-exchange, according to Hans-Joachim Voth, an economist at Barcelona's Pompeu Fabra university.

As the exchanges lose market share, they may not be able to retain the lucrative business that some of them have selling price and trading data. And as liquidity moves away, too, can they also retain their traditional role of price discovery? Mr Steil, for one, is optimistic that even if their share of trades shrinks, not much trading need take place through the exchanges for their prices to be useful indicators of value to off-exchange traders.

It amounts to another evolution from the traditional heart of the old exchanges: the floor on which traders once jostled as they called out their buy and sell orders. These floors have been dying out fast in the past decade, replaced by quieter electronic trading rooms. Mr Cappon reckons, plausibly, that the rest will go within maybe three years, with the possible exception of the famous NYSE trading floor. It might survive, he believes, in token form. It would primarily become a marketing tool, because “it makes such good television”.

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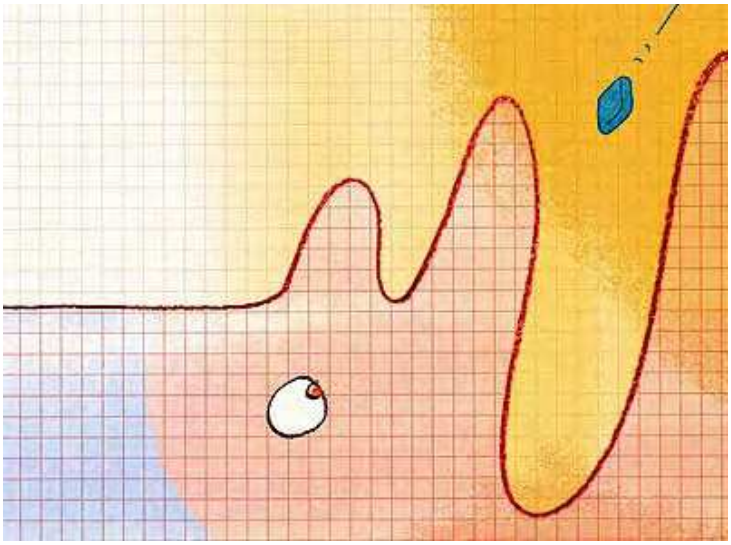
Global markets

The Viagra of volatility

May 25th 2006
From The Economist print edition

Financial markets, not for the faint-hearted, are febrile again



"SELL in May and go away" sounds like just the sort of old saw that lazy stockbrokers cling to when they need an excuse for a holiday and have nothing better to say to their clients. But as an explanation of why investors the world over have been selling shares since May 11th, it makes more sense than many others doing the rounds. As investors struggle to make sense of the blustery state of financial markets, conflicting stories abound. What is beyond dispute, however, is that volatility has staged a comeback.

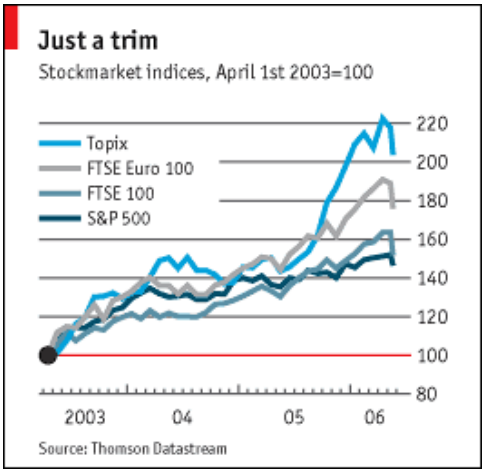
This week stockmarkets such as those in Turkey, Russia, Brazil and India (see article) fell sharply, as investors skimmed off some of the huge profits they had made in emerging markets in recent years. In Japan, continental Europe and Britain share prices bobbed about, but are down by almost 10% since the start of the sell-off—nearly enough to qualify as a correction. Commodities were especially jumpy. After a period of heavy selling, the price of copper rose by 11% on May 23rd, only to fall by 7% the next day.

The dollar was erratic, too. One day this week, its status as a safe haven shone, when it strengthened on fears about bird flu in Indonesia; then it faded a few hours later, after weak numbers on American-made durable goods, only to recover that afternoon on stronger sales of new homes. So far this year, the greenback has lost almost 8% against the euro and 5% against the yen. Yet foreign investors have still bought America's Treasury bonds. American shares have also been steadier than most in recent weeks (see chart)—although shares in Vonage, an internet telecoms company, fell by 13% on their stockmarket debut on May 24th, the worst first-day performance by an American technology share for almost two years (see article).

In London, two share offerings were pulled that same day. But around the world you can find signs of enduring optimism. Bank of China's initial public offering in Hong Kong, also on May 24th, raised $9.7 billion despite a 7% fall in the Hang Seng index in the preceding two weeks. This was the biggest share sale anywhere since 2000. The bids from America and Germany for Euronext, a European financial-exchange group, shows that some dealmakers are working around the clock.

Nevertheless, some hedge funds are suffering. Huw van Steenis, an analyst at Morgan Stanley in London, noticed long faces among the blooms at the Chelsea Flower Show's annual corporate bash on May 22nd. Prime brokers, who provide hedge funds with credit and loans of shares, told him that day had been the worst in three years for funds investing in shares. Mr van Steenis estimates that hedge funds with both long and short positions on shares have made 4-5% so far in 2006, having lost more than half this year's gains in the past month. Those who bet on mining and energy companies have wilted most.

So far, any talk of hedge funds shutting up shop has been vague. But below the surface, hedge funds may be making things worse for other investors. That, Mr van Steenis says, is because in the past fortnight they have been cutting their net exposure to falling stocks vigorously, by buying protection in the derivatives market. That results in further selling in cash markets, as counterparties who write the protection sell shares to hedge their own risk.



Talk of a generalised sell-off, as well as a "flight to quality"—ie, to highly liquid assets such as Treasury bonds—has inevitably inspired some commentators to leaps of faith about the months ahead. On the one hand, those who believe the world has been in the grip of a bear market since 2000, punctuated by a three-year rally since 2003, say that share prices will probably continue to slide. They point to higher interest rates and a possible slump in global housing markets and the dollar as dangers lurking just out of sight.

On the other hand, those who celebrate a long period of rising profits and moderate share valuations argue that markets are suffering from nothing worse than a bout of profit-taking while the world economy runs at full throttle. Ian Scott, a strategist at Lehman Brothers, notes that global share prices are trading on a forward price/earnings multiple of 13.8, compared with an average since 1988 of 17.5. Even if he supposes that profits grow only at their long-run average pace, he says, values are still lower than usual. That is a bullish sign.

Whatever the outcome, the turmoil could have erupted for many complex reasons, rather than a single simple one. Some have put it down to an inflation scare in America, heightened by an unexpectedly large rise in core consumer prices in April. But that explains neither why American assets have done better than most nor why the rally in Treasury bonds, which should flee inflation like leprosy.

Others ascribe the change of mood to a sudden dislike of risky assets, as if investors had woken up on May 11th with a pressing need to dump Brazilian shares or copper futures and buy something safer. This may sound far-fetched, but it makes some sense. Higher volatility means it is easier to lose money on risky assets, and there has been a flight to quality. Yet a consistent pattern is hard to find: emerging-market bonds, for example, have done much better than emerging-market shares.

In developed markets the share prices of medium-sized companies have fallen by more than large ones, but the prices of risky companies' bonds have barely fallen. Most of the assets that have fared worst in the past two weeks had enjoyed a good run; their falls may simply reflect profit-taking. According to Gray Newman, of Morgan Stanley, in Latin America enormous profits were waiting to be raked off. Between January 2003 and May 1st this year, Brazilian stocks had climbed by 490% in dollar terms, Mexico's by 219% and Colombia's by 716%. Such rises make the recent selling look much less troubling. "This is a bit of profit-taking," he says. "There's only real reason for concern if you believe we're going into a global recession."

That fear, that rising global interest rates might ultimately upset the delicate harmony of the world's Goldilocks economy, is probably the most credible—though, admittedly, the broadest—explanation for the markets' spasms, especially now that America's overheated housing market seems to be cooling (see article). It comes just as Ben Bernanke has made a slightly uncertain start to his tenure as chairman of the Federal Reserve. Markets are not yet sure how hard on inflation the new man will be. The European Central Bank looks sure to keep increasing interest rates, although there is room for doubt about how far and how fast. And the Bank of Japan is expected to raise rates too, although no one is quite sure when.

So, a guessing game has begun after two years in which monetary policy was boringly predictable, and speculators borrowed cheaply to make big "momentum" bets on rising markets. By April, stockmarket volatility had sunk so low that hedge-fund managers were complaining there were no trends left to follow.

Once again, financial markets have discovered the Viagra of volatility. Their concentration on economic data pumped out of sealed rooms by American officials has intensified. Policymakers, including Mr Bernanke, are reassessing the importance of off-the-cuff remarks. Traders are being forced to dig out their maths books to sharpen their grasp of derivatives. No longer is anything predictable about capital markets. Those who sell in May and go away may save themselves some money—but they will miss a lot of fun.

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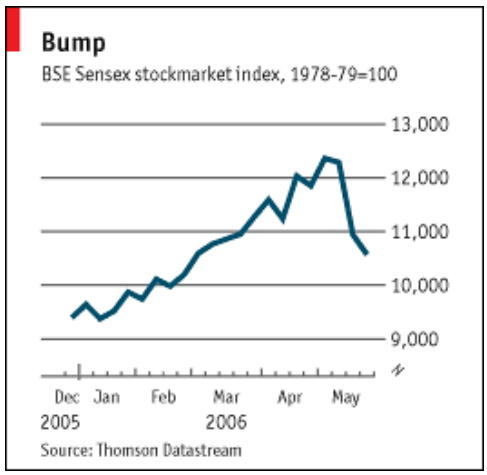
India's stockmarket

Back to earth

May 25th 2006 | DELHI
From The Economist print edition

After a giddying climb, investors get that sinking feeling



MANY investors around the world have been suffering from the churning stomach you feel when an aeroplane hits an air pocket. India's stockmarket has lost as much height, and as quickly, as almost any. On May 22nd, for the third trading session in a row, the main market index, the Sensex, set a record for its intra-day volatility. Trading was suspended for an hour after it had fallen by 10%. At that point, share prices had fallen by nearly 20% within two weeks. Even so, they were still worth 60% more than they had been a year earlier and were still up more than 10% since the beginning of the year. They recovered somewhat, but most analysts think that volatility is here to stay.

For the past three years, India's has been one of the best-performing stockmarkets in emerging economies. Not only has the country enjoyed economic growth averaging 7.5% a year, it also has some world-beating companies—and not just in software. So, according to research by analysts at Morgan Stanley, in 2005 it attracted 29% of the foreign funds flowing into seven big emerging markets (the other six were Brazil, the Philippines, South Korea, Taiwan, Thailand and Turkey). Its share the previous year was almost as big.

The market last suffered from similar nerves in May 2004 when today's government took office with the support of the Communists. After that, the Sensex tripled to reach its peak earlier this month. A “correction”, agreed analysts after the event, was “overdue”.

That this has been so severe was blamed on three things. One was a draft “instruction” from the tax authorities, misinterpreted as being directed at foreign investors. The second was that investors and traders were running out of cash to meet margin calls, and being forced to sell shares. The third was the government's apparent lurch towards populism after successes for the Communists in state elections this month (see article).

None of these explanations, however, seems as convincing as the simple observation that, having attracted disproportionate amounts of flighty portfolio inflows, India was always likely to suffer. Around the world, and in Japan in particular, economists have expressed concern about India's current-account deficit and the way it is financed—largely through portfolio inflows. At only 2.1% of GDP last year, the deficit does not seem especially large. But Japanese investors have heard the warnings. They have been among the biggest contributors to the Indian stockmarket boom. They are also among the quickest to go home now that the world seems a riskier place.

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Property prices

Going flat

May 25th 2006 | WASHINGTON, DC
From The Economist print edition

America's housing market is losing its effervescence

Getty Images

"NEW Price"; "Just Reduced"; "Priced to Sell". Once unheard of, these tags are cropping up ever more often in the property sections of America's newspapers. They denote a shift that is becoming clearer in the national statistics, too: the fizz is going out of the once-bubbly housing market. Compared with last year, inventories of unsold houses are up and the pace of sales is down. Prices have slowed and in some areas have even fallen.

The questions now are how deep the slowdown will be and whether it will be gentle or abrupt. Ben Bernanke, the chairman of the Federal Reserve, summarised the conventional view recently when he noted that the cooling seemed "very orderly and moderate at this point."

Just how moderate depends on the statistics you look at. America's most reliable measure of house prices, a quarterly index produced by the Office of Federal Housing Enterprise Oversight, is published with a long lag. Its most recent report, which covered the last three months of 2005, showed little sign of a slowdown. The median house price was 13% higher than a year earlier. Figures for the first quarter of 2006 will not come out until June 1st.

Quarterly figures from the National Association of Realtors, American estate agents' trade body, suggest that prices are slowing, but still rose by 10.3% in the first three months of 2006 compared with a year earlier. Monthly figures on the prices and pace of new and existing home sales have been more volatile, but the market is clearly slower than it was last year. According to figures released this week, the pace of new-home sales has bounced back since February, but is still 6% lower than in April 2005. The median price of new houses is less than 1% higher than a year ago. For the country as a whole, the era of double-digit price increases is over.

Perhaps most telling, builders have recently become a lot glummer. With Wells Fargo, a big bank, the National Association of Homebuilders publishes a monthly index of builders' perceptions of the housing market. This index fell by six points in May to 45, its lowest since 1995. (A score below 50 suggests that more builders reckon the market is poor than think it good.) Economists at Goldman Sachs estimate, from the fall in the homebuilders' index, that construction will fall at an annual rate of 10-15% in the next four quarters.

Builders are breaking far less new ground than they were. Housing starts fell at an annual rate of 56% between January and April this year, the sharpest slowdown since the early 1990s. The deceleration may have been exaggerated by the strong figure for January, when the weather was unseasonably warm, but the overall trend is clear.

Less frenetic building will be the most direct way that a weaker housing market affects the economy. Residential construction now makes up more than 6% of GDP. This suggests that a 10% drop would shave some 0.6 percentage points off economic growth. A bigger question, however, is how slower prices might affect consumer spending. Goldman Sachs's economists expect that America's house prices will have stopped rising by the end of the year. Mainly because Americans will have no extra equity against which to borrow and because a flat market will put a brake on residential building, this is expected to reduce GDP growth by about 1.5 percentage points. "Just Reduced" might soon be a fitting label for the whole economy.

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Fannie Mae

A ton of bricks

May 25th 2006 | NEW YORK
From The Economist print edition

Regulators take an American mortgage giant to task

ON MAY 24th, after three years' work, American regulators published a blistering, 340-page report on Fannie Mae, a giant, government-sponsored mortgage company. Fannie Mae, which had repeatedly overstated its profits, has been fined $400m and has agreed to a list of restrictions and reforms.

The Office of Federal Housing Enterprise Oversight (OFHEO), Fannie Mae's main regulator, found that the company had bloated its profits between 1998 and 2004 so that its bosses qualified for bigger bonuses. Of the $90m paid to Franklin Raines, the then chief executive, $52m was linked to profit targets. OFHEO also says that Fannie Mae used its huge political influence to thwart efforts to regulate it more tightly and that its internal controls and accounting systems were shoddy. The company's board and managers, says OFHEO, created an “arrogant and unethical corporate culture” in which “the ends justified the means”. Fannie Mae's reputation as a well run, low-risk company was a “façade”.

Fannie Mae has agreed to improve its internal controls, accounting and risk management. Until it does—which could take years, says James Lockhart, the acting director of OFHEO—Fannie Mae must limit its mortgage portfolio to $727 billion, its size at the end of 2005.

The company may have further difficulties to face. OFHEO's report adds fuel to efforts in Congress to contain Fannie Mae and Freddie Mac, its twin mortgage giant. Lawmakers and others fear the pair could pose a risk to the stability of America's financial system, because of the sheer size of their balance sheets and the market's belief that they, in effect, enjoy a federal-government guarantee. The Department of Justice, too, is investigating Fannie Mae's accounts. And the $400m settlement covers only the company, not its former executives, who are not yet out of the woods.

Eileen Fahey of Fitch Ratings, a credit-rating agency, points to a few crumbs of better news. Fannie Mae has already done some of the things that its regulators wish. With the mortgage market slowing and borrowers moving out of the fixed-rate mortgages that are Fannie Mae's bread and butter to adjustable-rate or other loans, Fannie Mae will be less affected by the cap on its mortgage assets than it could have been.

The cap could benefit Freddie Mac, the smaller of the two. Freddie Mac was also found to have misreported its earnings, but because its scandal came to light earlier, it has done more cleaning up. It also understated its profits, rather than overstating them. Last year Fannie Mae sold a lot of mortgage assets to meet its new regulatory capital requirements. Now the balance sheets of the siblings are almost the same size.

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MasterCard's flotation

Initial plastic offering

May 25th 2006 | NEW YORK
From The Economist print edition

A credit-card association reinvents itself

SOME things in life are “priceless”, according to MasterCard's long-running advertising campaign. By definition, the credit-card group's initial public offering, due to take place as *The Economist* went to press on May 25th, cannot fall into this category. In return for 46% of its equity, it was set to raise $2.4 billion.

However, MasterCard hopes that the resulting transformation of its structure will indeed prove invaluable. The flotation will change MasterCard from an association owned by thousands of member banks into a more transparent, listed company. Most of the money raised will be split among the banks, which between them will keep 44% of the shares, but no voting rights. The remaining 10% of the shares and one-fifth of the votes will go to a non-profit foundation.

This, MasterCard hopes, will put an end to the litigation and regulatory scrutiny that have dogged it in recent years. Specifically, it intends to disarm critics who claim that, through MasterCard and its rival, Visa, the banks abuse a dominant position in the credit-card market. The two competing associations, which have been joint defendants in many lawsuits, have 83% of America's payment-card market by value of transactions, according to the *Nilson Report*, a trade publication. That the banks will have less than half the shares and no voting rights should, believes MasterCard, put an end to the argument that they can exploit the group's market power.

The change is not only defensive. It also frees MasterCard to form alliances with non-banks. For instance, mobile-phone companies are keen to offer customers the ability to use their phones to pay for all sorts of things, but they need a payment network to do so. Insurers and internet companies are other possible partners. The banks might not have been willing to see MasterCard develop businesses that competed with their own.

“MasterCard is a fantastic company in a booming industry,” enthuses Ryan Batchelor of Morningstar, a research firm. The plastic-card business is thriving the world over as people switch from cheques and cash. MasterCard seems well placed to gain from its growth.

Like Visa, it is made up of two parts. First, it has card brands, such as MasterCard and Maestro. Banks pay a fee, based on the value of transactions, to issue cards using these marques. Second, it owns a payment network linking banks, retailers and consumers. It charges banks (which in turn charge consumers and merchants) for services such as the clearing and settlement of credit-card transactions. This business makes up two-thirds of MasterCard's revenues and because almost all its costs are fixed, any increases in revenue pass straight through to profits. Mr Batchelor reckons that, after stripping out the cost of litigation, MasterCard's operating margins have grown by about 2% a year for the past five years and will continue to expand, if more slowly.

Some analysts are much less optimistic. Their foremost worry is the cost of litigation: the legal and regulatory actions against MasterCard filled 12 pages of the prospectus for the share offering. In particular, they do not think that the $650m MasterCard plans to set aside for fighting lawsuits will be nearly enough. After all, in 2003 MasterCard settled an antitrust suit brought by Wal-Mart and others for $1 billion. In the past, MasterCard could pass these costs on to its member banks. It is giving up the right to do this as part of the terms of its flotation, so shareholders will foot future bills. Standard & Poor's, a credit-rating agency, said it would downgrade MasterCard for just this reason.

Nor have the banks departed the scene altogether. They will still have some influence, because they will not only retain some shares but also elect three directors to the board. Some see the granting of one-fifth of the voting rights to the foundation as a ploy to keep control: although public shareholders will wield four-fifths of the votes, near-unanimity will be required for some decisions.

The sceptics are also worried about MasterCard's competitive position. In America it lags a long way behind Visa. According to the *Nilson Report*, in 2005 MasterCard-branded cards recorded 9 billion transactions, whereas Visa's counted 21 billion. Of the six issuers that together control over 75% of America's card market, only one, Citibank, favours MasterCard. Alone, it issues 27% of the group's American credit cards. Outside America, says the *Nilson Report*'s David Robertson, MasterCard is losing market share to Visa everywhere but Canada: abroad, even Citibank goes with Visa.

Still, MasterCard is doing nicely. Its first-quarter profits were 36% higher than in the same period last year, at $127m. Although Visa is scoffing a larger share of the pie, the pie is getting bigger and bigger, particularly outside America. The optimists think that this trend will make MasterCard a winner in the long run, even if lawsuits hurt it in the short run. Mr Batchelor points to Philip Morris, a cigarette maker. Not long ago investors shunned it because of the enormous risk of litigation. But over the long haul, he says, it has been “a cash cow—and a terrific investment”.

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Milberg Weiss

The boot's on the other foot

May 25th 2006 | NEW YORK
From The Economist print edition

The legal scourge of American companies is itself accused

FOR years a lawsuit from Milberg Weiss Bershad & Schulman has been a common aftershock for American companies hit by financial earthquakes. After a sharp decline in a firm's share price, Milberg Weiss would threaten a class-action suit on behalf of shareholders allegedly cheated into buying overpriced equity. The company would typically settle, in effect compensating shareholders with their own money—a slice of which went to Milberg Weiss.

To Milberg Weiss and its sympathisers, this is civil justice; to the companies forced to pay, it is a shake-down. The defendants enjoyed a form of redress on May 18th when two of Milberg Weiss's senior partners, David Bershad and Steven Schulman, and the firm itself were indicted by a grand jury in California on criminal charges of racketeering, fraud, conspiracy and other things. The firm is said to have used a small stable of illicitly paid “lead plaintiffs” to start lawsuits. The indictment, which notes that Mr Bershad has been paid $161m since 1983 and Mr Schulman $67m since 1991, also refers to two unnamed partners. No one would be shocked if more charges were filed.

The indictment says that more than $11m was paid to three men who (sometimes through relatives) played a decisive role in cases in which Milberg Weiss received more than $200m in fees. If true, this would be a straightforward breach of laws barring anyone representing a class from receiving payments that would place his interest at odds with that of his fellow claimants. The plaintiffs were paid through complex and secret channels, involving a safe hidden in Mr Bershad's office, other law firms and even casinos. In other ways, however, Milberg Weiss was quite open. Two of the plaintiffs took part in 70 suits each, the other in 40. The men's investments in the firms they sued were often trivial. Given that, it would be fair to find out why they troubled to go to law.

So why did none of the besieged companies bother? The larger ones certainly have the resources to hire private investigators to look into plaintiffs. And they have had plenty of time; the California inquiry has been going on for more than five years and the alleged practices for more than two decades. A possible explanation is that not much can be done—perhaps not even a successful prosecution—to cut back litigation in Milberg Weiss's style.

One of the more disturbing possibilities, says Jonathan Macey, a professor at Yale Law School, is that this kind of litigation has numerous beneficiaries besides Milberg Weiss. The techniques spawned by the firm have created lots of business for lawyers—both those who mimic Milberg Weiss and those who defend companies. Law firms engaged in such suits have become generous donors to politicians, especially Democrats. Insurers have seen a dramatic increase in demand for policies that protect directors and officers from personal liability in cases of this kind. All these groups now have an interest in keeping this form of litigation going.

Even companies' directors have been complicit in this to some extent, by reasoning that settling lawsuits with shareholders is cheaper and easier than fighting. It has been suggested that, if the Californian prosecutors prevail, companies that had settled with Milberg Weiss may try to recover money the firm kept as fees. Just as likely, they will want to avoid admitting that they rolled over too quickly.

Milberg Weiss now has so many imitators that even if the firm dissolved, it would hardly be missed. And there is nothing to stop its other partners from setting up shop elsewhere. In 1995 Congress, despite Bill Clinton's veto, changed the rules of class-action litigation, requiring the lead plaintiff to have a significant economic interest. That took care of the practices alleged in the California suit. However, lawyers are nothing if not creative. In shareholder litigation these days, plaintiff law firms are hired by states and public pension funds rather than individuals. The politicians behind these institutional plaintiffs are allowed to receive donations from law firms they might hire, and do. Although paying a plaintiff directly is a crime, this indirect method is not.

The case against Milberg Weiss does not address the economic lunacy of the kind of litigation in which the firm specialised, but rather a quirk in how suits are begun. Milberg Weiss was always open about having an entrepreneurial business model. It justified its suits by saying that it was pursuing cases that state attorneys-general should have taken up but did not. It styled itself as a private attorney-general, with better resources and knowledge than the public variety but with the same aim—punishing miscreants. It did this by dredging money out of companies with the approval of the courts. Suing companies for their managers' errors, however, merely hurts shareholders a second time. A better route to redress for shareholders may be to go after the executives

themselves.

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Italian banks and pawnbroking

In hock

May 25th 2006 | PALERMO
From The Economist print edition

A 500-year-old business is still going strong

BANCO DI SICILIA, part of Capitalia, a large Italian banking group, is spring-cleaning its vaults. Items against which the Sicilian bank has lent money, including watches, jewellery and silverware, are due to be auctioned between May 28th and June 3rd. Among the items on the block are a white-gold and diamond bracelet, for which the bidding is expected to start at €8,000 ($10,200), and a gold Rolex watch, for which the auctioneer will ask at least €7,000.

About 200 people call at the bank's pawnbroking branch in Palermo each day. They can expect to raise just over half of the market value of their goods. “Most of those who borrow are needy and we usually lend the maximum permitted by law,” says Gioacchino Chiavetta, head of Banco di Sicilia's pawn business. The bank holds regular sales of unredeemed items, besides next week's special spring auction. Proceeds in excess of the bank's loan, less 5%, go to the borrower.

In Sicily pawn lending began in the early 16th century with two banks, one dealing with precious items like jewellery and silverware and the other with ordinary objects like farm implements. Banco di Sicilia entered the business only in the late 1990s when it absorbed Sicilcassa, the island's savings bank, and its ten pawn branches.

On the mainland the business is even older: the first pawn lender was founded in 1452 by Franciscan monks in Perugia to combat usury. The Monte dei Paschi di Siena, which claims to be the world's oldest bank, began in the pawn business and is still in it. Banca Regionale Europea, a northern bank, has nine pawn branches, having absorbed the Banca del Monte, an institution founded in 1496 that was Milan's oldest bank, and Pavia's pawn bank, established in 1493.

Sanpaolo-IMI, a large group based in Turin, has five pawn businesses and holds auctions every two days. It has about €45m-worth of pawn loans on its books, but trade is declining. But Capitalia's own pawn business in Rome, which has weekly auctions, grew by almost 10% last year. The bank says some customers use it as a frequent source of credit. Banco di Sicilia's business also expanded—a sign, perhaps, of Italy's yawning north-south economic gap. The needs once met by 15th-century monks endure: it is said that some pawn their goods in order to pay loan sharks.

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Economics focus

McCurrencies

May 25th 2006
From The Economist print edition

Happy 20th birthday to our Big Mac index

The hamburger standard

	Big Mac prices		Implied PPP* of the dollar	Actual dollar exchange rate May 22nd	Under (–)/ over (+) valuation against the dollar, %
	in local currency	in dollars			
United States†	$3.10	3.10	–	–	–
Argentina	Peso 7.00	2.29	2.26	3.06	-26
Australia	A$3.25	2.44	1.05	1.33	-21
Brazil	Real 6.40	2.78	2.06	2.30	-10
Britain	£1.94	3.65	1.60‡	1.88‡	+18
Canada	C$3.52	3.14	1.14	1.12	+1
Chile	Peso 1,560	2.94	503	530	-5
China	Yuan 10.5	1.31	3.39	8.03	-58
Czech Republic	Koruna 59.05	2.67	19.0	22.1	-14
Denmark	DKr27.75	4.77	8.95	5.82	+54
Egypt	Pound 9.50	1.65	3.06	5.77	-47
Euro area§	€2.94	3.77	1.05**	1.28**	+22
Hong Kong	HK$12	1.55	3.87	7.75	-50
Hungary	Forint 560	2.71	181	206	-12
Indonesia	Rupiah 14,600	1.57	4,710	9,325	-49
Japan	¥250	2.23	80.6	112	-28
Malaysia	Ringgit 5.50	1.52	1.77	3.63	-51
Mexico	Peso 29.00	2.57	9.35	11.3	-17
New Zealand	NZ$4.45	2.75	1.44	1.62	-11
Peru	New Sol 9.50	2.91	3.06	3.26	-6
Philippines	Peso 85.00	1.62	27.4	52.6	-48
Poland	Zloty 6.50	2.10	2.10	3.10	-32
Russia	Rouble 48.00	1.77	15.5	27.1	-43
Singapore	S$3.60	2.27	1.16	1.59	-27
South Africa	Rand 13.95	2.11	4.50	6.60	-32
South Korea	Won 2,500	2.62	806	952	-15
Sweden	SKr33.00	4.53	10.6	7.28	+46
Switzerland	SFr6.30	5.21	2.03	1.21	+68
Taiwan	NT$75.00	2.33	24.2	32.1	-25
Thailand	Baht 60.00	1.56	19.4	38.4	-50
Turkey	Lire 4.20	2.72	1.35	1.54	-12
Venezuela	Bolivar 5,701	2.17	1,839	2,630	-30
Aruba	Florin 4.95	2.77	1.60	1.79	-11
Bulgaria	Lev 2.99	1.94	0.96	1.54	-37
Colombia	Peso 6,500	2.60	2,097	2,504	-16
Costa Rica	Colon 1,130	2.22	365	510	-28
Croatia	Kuna 15.0	2.62	4.84	5.72	-15
Dominican Rep	Peso 60.0	1.84	19.4	32.6	-41
Estonia	Kroon 29.5	2.40	9.52	12.3	-23
Fiji	Fiji $4.65	2.69	1.50	1.73	-13
Georgia	Lari 4.15	2.31	1.34	1.80	-26
Guatemala	Quetzal 17.25	2.27	5.56	7.59	-27
Honduras	Lempira 35.95	1.90	11.6	18.9	-39
Iceland	Kronur 459	6.37	148	72.0	+106
Latvia	Lats 1.35	2.47	0.44	0.55	-20
Lithuania	Litas 6.50	2.41	2.10	2.69	-22
Macau	Pataca 11.1	1.39	3.59	7.99	-55
Moldova	Leu 23.0	1.75	7.42	13.2	-44
Morocco	Dirham 24.5	2.82	7.92	8.71	-9
Norway	Kroner 43.0	7.05	13.9	6.10	+127

Guatemala	Quetzal 17.25	2.27	5.56	7.59	-27
Honduras	Lempira 35.95	1.90	11.6	18.9	-39
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Moldova	Leu 23.0	1.75	7.42	13.2	-44
Morocco	Dirham 24.5	2.82	7.92	8.71	-9
Norway	Kroner 43.0	7.05	13.9	6.10	+127
Pakistan	Rupee 130	2.16	41.9	60.1	-30
Paraguay	Guarani 9,000	1.63	2,903	5,505	-47
Saudi Arabia	Riyal 9.00	2.40	2.90	3.75	-23
Slovakia	Koruna 58.0	1.97	18.7	29.5	-37
Slovenia	Tolar 520	2.76	168	189	-11
Sri Lanka	Rupee 190	1.85	61.3	103	-40
Ukraine	Hryvna 8.50	1.68	2.74	5.05	-46
UAE	Dirham 9.00	2.45	2.90	3.67	-21
Uruguay	Peso 42.3	1.77	13.6	23.9	-43

*Purchasing-power parity: local price divided by price in United States

Sources: McDonald's; *The Economist* †Average of New York, Chicago, Atlanta and San Francisco ‡Dollars per pound §Weighted average of prices in euro area **Dollars per euro

WHEN our economics editor invented the Big Mac index in 1986 as a light-hearted introduction to exchange-rate theory, little did she think that 20 years later she would still be munching her way, a little less sylph-like, around the world. As burgernomics enters its third decade, the Big Mac index is widely used and abused around the globe. It is time to take stock of what burgers do and do not tell you about exchange rates.

The Economist's Big Mac index is based on one of the oldest concepts in international economics: the theory of purchasing-power parity (PPP), which argues that in the long run, exchange rates should move towards levels that would equalise the prices of an identical basket of goods and services in any two countries. Our “basket” is a McDonald's Big Mac, produced in around 120 countries. The Big Mac PPP is the exchange rate that would leave burgers costing the same in America as elsewhere. Thus a Big Mac in China costs 10.5 yuan, against an average price in four American cities of $3.10 (see the first column of the table). To make the two prices equal would require an exchange rate of 3.39 yuan to the dollar, compared with a market rate of 8.03. In other words, the yuan is 58% “undervalued” against the dollar. To put it another way, converted into dollars at market rates the Chinese burger is the cheapest in the table.

In contrast, using the same method, the euro and sterling are overvalued against the dollar, by 22% and 18% respectively; the Swiss and Swedish currencies are even more overvalued. On the other hand, despite its recent climb, the yen appears to be 28% undervalued, with a PPP of only ¥81 to the dollar. Note that all emerging-market currencies also look too cheap.

The index was never intended to be a precise predictor of currency movements, simply a take-away guide to whether currencies are at their “correct” long-run level. Curiously, however, burgernomics has an impressive record in predicting exchange rates: currencies that show up as overvalued often tend to weaken in later years. But you must always remember the Big Mac's limitations. Burgers cannot sensibly be traded across borders and prices are distorted by differences in taxes and the cost of non-tradable inputs, such as rents.

Despite our frequent health warnings, some American politicians are fond of citing the Big Mac index rather too freely when it suits their cause—most notably in their demands for a big appreciation of the Chinese currency in order to reduce America's huge trade deficit. But the cheapness of a Big Mac in China does not really prove that the yuan is being held far below its fair-market value. Purchasing-power parity is a long-run concept. It signals where exchange rates are eventually heading, but it says little about today's market-equilibrium exchange rate that would make the prices of tradable goods equal. A burger is a product of both traded and non-traded inputs.

An idea to relish

It is quite natural for average prices to be lower in poorer countries than in developed ones. Although the prices of tradable things should be similar, non-tradable services will be cheaper because of lower wages. PPPs are therefore a more reliable way to convert GDP per head into dollars than market exchange rates, because cheaper prices mean that money goes further. This is also why every poor country has an implied PPP exchange rate that is higher than today's market rate, making them all appear undervalued. Both theory and practice show that as countries get richer and their productivity rises, their real exchange rates appreciate. But this does not mean that a currency needs to rise massively today. Jonathan Anderson, chief economist at UBS in Hong Kong, reckons that the yuan is now only 10-15% below its fair-market value.

Even over the long run, adjustment towards PPP need not come from a shift in exchange rates; relative prices can change instead. For example, since 1995, when the yen was overvalued by 100% according to the Big Mac index, the local price of Japanese burgers has dropped by one-third. In the same period, American burgers have become one-third dearer. Similarly, the yuan's future real appreciation could come through faster inflation in China than in

the United States.

The Big Mac index is most useful for assessing the exchange rates of countries with similar incomes per head. Thus, among emerging markets, the yuan does indeed look undervalued, while the currencies of Brazil, Turkey, Hungary and the Czech Republic look overvalued. Economists would be unwise to exclude Big Macs from their diet, but Super Size servings would equally be a mistake.

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Finance writer

May 25th 2006
From The Economist print edition

The Economist is looking for an experienced observer of the world's capital markets to write for the Finance and Economics section. Salary negotiable. Curiosity and enthusiasm essential. Applicants should submit an original and unpublished test piece of no more than 650 words that they think suitable for the section. They should also send two further ideas for articles. Please send them, with a curriculum vitae, to Finance Writer, The Economist, 25 St James's Street, London, SW1A 1HG, or to financewriter@economist.com, by June 30th.

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Medicine

From hand to mouth

May 25th 2006 | ATLANTA, GEORGIA
From The Economist print edition

A new superbug is stalking the world

Alamy

IF YOU are unfortunate enough to catch it, you will suffer from intractable diarrhoea with gut-searing pain and fever. If you are frail, you may die. Should you survive, you may be stricken by repeated bouts of sickness. The disease is so debilitating that some turn to a treatment that is stomach-churning in its own right: enemas containing the faeces of a healthy donor, often a spouse. Although methicillin-resistant *Staphylococcus aureus* (MRSA) is more famous, *Clostridium difficile* is a superbug to be reckoned with. Like many other infections caught in hospital, it is increasingly becoming resistant to treatment with antibiotics.

Ordinarily, the human colon harbours very few of the rod-shaped bacteria that cause *Clostridium difficile* associated disease or CDAD. But the guts of those people who are given antibiotics to prevent or treat infection during a stay in hospital are different. Antibiotics may rid the colon not only of harmful bacteria, but also of the beneficial ones that normally live there. This, in turn, can give *C. difficile* the chance to take hold.

Rates of the disease among patients in, or recently discharged from, American short-stay hospitals seem to have doubled between 2000 and 2003 and risen another 25% in 2004, the most recent year for which estimates are available. That translates into at least 225,000 new cases a year, according to the Centres for Disease Control, a government agency based in Atlanta, Georgia. As this number does not capture all of America's hospitals and ignores its nursing homes, the real figure is probably at least 500,000 cases a year.

What lies beneath

The full extent of the illness is unclear because American hospitals are not required to report it. Even when someone with the disease dies, his death certificate may not say he had it. Whatever the true numbers, about 20% of people infected have repeated bouts of the illness and some 1-2% of the stricken die; chiefly, but not exclusively, the victims are elderly people who are already in frail health.

Worryingly, the disorder is now being found in people who have not stayed in hospital. This new sort of case includes 48 pregnant women, one of whom died along with her fetus; others miscarried. Some of the people who seem to have caught the disease outside hospital had recently been on antibiotics; early studies suggest that others may have picked up the disease from eating infected animals or by taking medicines to combat heartburn and indigestion.

Australia, Belgium, Britain, Canada and Japan have been grappling with the problem, too. In Britain since January 2004, all health-care facilities in National Health Service trusts—not just hospitals—have to report every case in a person aged 65 and older. Acute-care hospitals in Quebec, in Canada, must report every case that strikes within a

month of a patient's being discharged, regardless of his age.

Three American federal agencies—the National Institutes of Health, the Food and Drug Administration and the Centres for Disease Control—are so alarmed that they recently convened a workshop in Atlanta to determine what research is needed to tackle the disease.

Unlike many bacteria, *C. difficile* makes poison-forming spores. These spores are, in effect, reservoirs for infection. Only when they hatch in the intestines do they produce their toxins. About half the hospital patients infected after taking antibiotics have no symptoms of CDAD. But they still shed spores and so are carriers.

The spores can survive for months on virtually everything they touch: toilets, bedpans, bathroom floors, sheets, bed rails, call buttons, telephones and door-knobs. The spores cling to the hands of hospital staff, lurking under fingernails and rings. A good defence is for doctors and nurses to wash their hands meticulously with soap and water between seeing each patient, but that is not easy to enforce. Alcohol-gel hand-cleaners are more convenient than hand-washing, but are less effective. Household bleach is the most efficient killer of *C. difficile* spores, but most hospitals do not routinely apply it to every patient's room, let alone to communal areas.

What else can be done to combat *C. difficile*? Dale Gerding of the Loyola Stritch Medical School in Maywood, Illinois, wants a sensitive, rapid and affordable test for the diagnosis of CDAD and the prompt identification of carriers. Such a test could rely on a technique known as “polymerase chain reaction” to magnify a small sample to the point where testing becomes relatively easy. Several companies are developing such tests but none is ready for widespread use.

Moreover, there is a problem: *C. difficile* grows poorly in the laboratory—which is why it was named “difficile” when it was discovered in the 1930s. The name is still well deserved. Molecular biologists are still struggling to pin down the bacteria's genes and their behaviour—in order, among other things, to verify the apparent emergence of more virulent strains of the bacterium. Fortunately, there are other kinds of bacteria that form spores in much the same way as *C. difficile* does. These are being used to understand exactly how the genes responsible for making spores work, which in turn may make it possible to switch them off.

Can you get better?

Patients also need treatments to cure sudden, severe cases of the disease. Two drugs, metronidazole and vancomycin, are commonly prescribed for *C. difficile*, but both are antibiotics that can themselves predispose patients to relapses. Ciaran Kelly, a Harvard Medical School researcher, says that broad-spectrum antibiotics—used to treat many different kinds of bacteria—tend to make many species of bacteria resistant to them, and limit the treatments available for CDAD. Antibiotics designed especially to act against *C. difficile* would be far less likely to affect other bacteria: some in late-stage clinical trials give cause for hope.

Another advance could come from inactivating the spores. Two drugs that could have been useful—cholestyramine and colestipol—are already on the market. Unfortunately, their effects have, to date, been modest. Neither was developed for *C. difficile*, and they do not bind well to its spores. At least one newer candidate—tolevamer—could, in principle, do a better job by binding not to the spores but to the toxins they produce. It, too, is in late-stage clinical trials. Because it is a synthetic polymer, not an antibiotic, it should not destroy the good, protective bacteria along with the bad ones in the gut. At the very least it would be more pleasant than some of the treatments patients turn to today.

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Optical materials

Cast no shadows

May 25th 2006
From The Economist print edition

How to weave a cloak that makes you invisible

IN NORSE mythology, a magic cloak granted invisibility to Sigurd, a demi-god and skilled warrior with superhuman strength. Millennia later, a similar garment bestowed invisibility on Harry Potter, a schoolboy wizard. In the mortal (or Muggle) realm, engineers have for years tried with varying degrees of success to build such a device. This week a team of physicists and materials scientists announced it had devised a pattern for a potentially perfect invisibility cloak.

Light is an electromagnetic wave, with a longer wavelength than X-rays and ultraviolet, and a shorter wavelength than infra-red, microwaves and radio waves. All these electromagnetic waves are governed by four mathematical expressions established almost 150 years ago by James Clerk Maxwell. These equations represent one of the most elegant and concise ways to state the behaviour of electric and magnetic fields and how they interact with matter. However, because they are so concise, they also embody a high level of mathematical sophistication.

The team—Sir John Pendry of Imperial College London with David Schurig and David Smith of Duke University in North Carolina—used the equations to devise a way to cloak an object with a material that would deflect the rays that would have struck it, guide them around it and return them to their original trajectory. Maxwell's equations conserve certain properties—the magnetic field intensity, the electric displacement field and the Poynting vector that describes the electric flux of an electromagnetic field. These properties remain the same when others are altered. The team showed how these fields could be manipulated to flow around objects like a fluid, returning undisturbed to their original paths. The findings were published online this week by *Science*.

The trick is to use metamaterials: materials that owe their characteristics to features of their structure that are smaller than the wavelength of the electromagnetic radiation. For light, this is on the scale of tens of thousandths of a millimetre. Metamaterials can and have been designed and made to possess certain properties, even counter-intuitive ones. Using metamaterials means the scheme should work for all objects, regardless of their shape. Moreover, unlike other proposed invisibility cloaks, it does not require knowledge of what is behind the wearer, nor are crude projections involved.

So far, so good: the theory is in place. Sadly, the implementation lags behind. Moreover, there are several other difficulties that may prevent a device conferring total invisibility from being built. The first is that the plan described by Sir John and his colleagues works only for a small range of wavelengths. A surgeon wearing metamaterial gloves tuned to make his hands invisible might benefit from being able to see exactly where the scalpel was cutting. However, an invisibility cloak designed to hide something from people who were looking for it would not work. An aeroplane shrouded in such kit might be invisible to the human eye but it would be picked up readily by radar, which operates at radio wavelengths.

Even if it ultimately proved possible to make an aeroplane completely invisible at all wavelengths, there would be a further problem. According to the laws of physics, an invisible person would necessarily be blind. In order to see light, the eye must absorb it, but in order for a person to be invisible, the body must not absorb any light. Thus, a spy plane could not be completely invisible if it were to be used for espionage or, indeed, flown at all, since its pilots would need to know its position relative to the ground.

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Epigenetics

A curious tail

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Mice inherit more than just DNA

IN THE 1860s, although nobody paid much attention at the time, a monk pottering around with pea plants established the basic rules of genetic inheritance. Gregor Mendel's laws of heredity say that humans (and most other organisms) inherit two sets of genes unchanged, one from each parent. In modern terms, this means that one's genetic inheritance comes from the DNA that forms these genes. But over time Mendel's rules have been broken, and exceptions to these laws have been discovered. Growing evidence suggests that genetic information comes from places other than inherited DNA.

Minoo Rassoulzadegan and colleagues working at Inserm, a health-research institute in Nice, in France, and the nearby University of Nice-Sophia Antipolis have found a gene in mice that rather spookily seems to express characteristics that are not encoded in the DNA it received from its parents. The gene is called *Kit* and mice with a mutant *Kit* gene have white patches on their tails and feet.

In one experiment, mice with two versions of the gene, a normal and a mutant version, were crossbred. Some of their offspring, by chance, inherited two normal versions of the gene. Curiously, most of these offspring had white spotted tails. In other words, they looked as though they had inherited a mutant version of the *Kit* gene, even though their DNA sequence showed that they had not. Somehow, the mice had acquired the genetic information for white spotted tails.

The explanation, says the team, seems to come from RNA, a molecule whose main role is to act as a template for translating DNA into the proteins that perform a wide variety of biological functions in the body. Unusual amounts of RNA were found in the sperm from mice with the mutant *Kit* gene, leading the group to suspect that RNA was implicated.

When this RNA was extracted and injected into mice embryos, a white-tailed mutant was created—even though no genes for the white tail were present. This work shows that the inheritance is mediated by RNA but the precise mechanism is unclear. The inherited RNA could be interfering with messages sent by the inherited DNA, or it could be directly modifying inherited DNA.

The work is evidence of a phenomenon called paramutation, in which orders issued by a version of a gene (an allele, in the jargon) in one generation are remembered in subsequent generations, even if the allele itself has not been inherited. Paramutation has been seen mostly in plants, but something similar has been suspected in mammals, including humans. Some studies have shown that the effect can persist across generations, which means that genes that were not inherited from your great-grandparents could still be exerting an influence today.

Paul Soloway, a molecular geneticist at Cornell University in New York, says some human traits could be affected by paramutation. In 1997 one study showed that children with genes making them susceptible to diabetes were resistant to the disease if their father had had a copy of a resistant gene, even though they had not inherited it through his DNA.

More broadly, paramutation is part of a growing list of “epigenetic” effects—hereditary changes in gene function put down to chemical changes rather than the sequence of DNA. Epigenetics may, for example, explain how one identical twin develops schizophrenia whereas the other does not. Dr Rassoulzadegan thinks that there are too few human genes to explain all the differences between people. It may well be that epigenetics provides part of the answer.

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Forest management

The kindest cut

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Cutting down trees could be the best way to preserve tropical forests

Get article background

DEPRESSING reports about how quickly the world's tropical forests are being felled are commonplace. But depressing reports about the state of the trees that are still standing are much rarer. In fact, a new study from the International Tropical Timber Organisation (ITTO), an offshoot of the United Nations, claims to be the first exhaustive survey of tropical-forest management ever undertaken. Its findings, although grim, do contain a kernel of hope.

The ITTO examined “permanent forest estate”, meaning land that the governments of its 33 members have formally set aside for forests, and is therefore subject to some form of regulation or protection. The category includes both national parks and timber concessions, in both public and private hands. It covers 814m hectares, and accounts for roughly two-thirds of the world's tropical forests.

The concept is important, explains Duncan Poore, one of the authors of the report, because it is not always possible, or desirable, to protect every last grove against encroaching farms or homes. Instead, governments should concentrate on maintaining the forests that are the most commercially and scientifically valuable. Yet the ITTO's researchers found that only 15% of the permanent forest estate has a management plan, and less than 5% of it is sustainably managed. That still amounts to an area the size of Germany, the report notes, and represents a dramatic improvement since 1988, when an earlier and less extensive survey found that only one country in the tropics—Trinidad and Tobago—had any well-run forests at all. But relative to the area of forest that has disappeared over the same period, the well-managed area is negligible.

The crux is bad government. Poor countries do not always have good forestry laws. Even when they do, they rarely have the capacity to enforce them. It is no coincidence that Malaysia, the country with the highest proportion of prudently managed forest in the study, is also one of the richest. Countries with the worst run forests, meanwhile, are war-torn places such as Congo and Cambodia.

More surprising, perhaps, is the difference the report found between forests where logging is allowed, and those that have been earmarked for conservation. Some 7% of “production” forests, it turns out, are in good shape, compared with just 2.4% of “protection” forests. As Dr Poore points out, it is easy to undertake to preserve a forest, but difficult to do so in practice. Timber concessionaires at least have an incentive (and probably the wherewithal) to look after their property, while ill-paid and ill-equipped forestry officials often have neither. Exploiting forests may prove the best way to preserve them.

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About sponsorship

Contemporary art in Italy

The line of beauty

May 25th 2006 | ROME AND VENICE
From The Economist print edition

Opening a contemporary-art museum in Italy is as much about deal-making as it is about donations, as two collectors have recently discovered

MAXPPP

THE Medici are a hard act to follow. Nevertheless, two European businessmen are striving to turn themselves into modern princes of patronage. François Pinault, a French billionaire, has filled Palazzo Grassi in Venice with some of the most famous names in contemporary art, while a Florida-based Italian perfume magnate, Carlo Bilotti, has given 19 Giorgio De Chirico paintings to the city of Rome and is lending a selection of other works in return for having a public museum named after him. Both men negotiated carefully with the cities' mayors. It is not clear yet whether the magnates or the municipalities have the better end of the deals, but both cities now boast new spaces for modern art, which are all too rare in Italy.

Mr Pinault's show at Palazzo Grassi is the more grandiose affair and offers an insight into the taste of the modern billionaire. Soon after abandoning plans to build a museum on an island in the River Seine, Mr Pinault paid the city of Venice €28.5m ($36.6m) for an 80% interest in one of its grandest sites—at one time an art venue run by Fiat. The French magnate likes his culture on a global scale: "I run my art collection like my businesses," he says. "I look at what is happening all over the world. I have teams of people on different continents who have their ear to the ground. It isn't enough to be able to buy art. There is a limited supply and a lot of competition. To buy the best art from the best artists—and I work closely with 25 to 30—you have to visit their studios and build relationships with them and their dealers."

For the visitor, though, Palazzo Grassi is a little like a zoo, housing every major species of modern artist—sculptor, painter, installation-maker and video-producer. Mr Pinault, the biggest shareholder in Christie's, appears to have snapped up prime works from the major exhibitions and art fairs of the past decade, filling in gaps by buying entire collections—the Mellon Rothkos, for example, and the Stein collection of Arte Povera—which may explain why there is something of a greatest-hits compilation about this display.

Olafur Eliasson, a Danish installation artist, has clothed the façade in a striking spider-web of light. Inside, Damien Hirst's glass menagerie of pickled pets occupies a vast salon with frescoed ceilings overlooking the Grand Canal, and reflects the light and water outside. Urs Fischer, a Swiss artist, has an eye-popping installation of orange raindrops that appear to fall from the ceiling of the atrium. And Jeff Koons has installed his high-kitsch inflatable heart sculpture (pictured above) just inside the Grand Canal entrance.

Although the collection offers Venetians a rare opportunity to see contemporary art outside the Biennale, the installation can seem unsympathetic. Much of the interior of Palazzo Grassi has been turned by the project's architect, Tadao Ando, into a warren of white cubes, particularly the corridors that house the paintings of Gerhard Richter, Luc Tuymans and Lucio Fontana—all world-class artists, but none represented here by his best work. A cycle of canvases by Cy Twombly, one of the greatest living painters, is squeezed into a cramped, dimly lit room that serves as a hallway between two other galleries. Even Rothko's work—gorgeous paintings from his classic

period—seems to jostle for space in this vast palace of art.

Given that Palazzo Grassi is on the Grand Canal, it is impossible to avoid comparison with the Peggy Guggenheim collection farther along the water. Mr Pinault's selection is certainly star-studded, but it lacks the personal passion and engagement with Venice that pervades the Guggenheim, making it one of the most magical places to look at art. The new Carlo Bilotti Museum in Rome, by contrast, offers a far more intimate connection with artists. A tiny cameo in comparison with Mr Pinault's crown jewels, Mr Bilotti's collection of De Chirico paintings is displayed in a converted Renaissance orangery in the gardens of the Villa Borghese.

The Roman painter was Mr Bilotti's first love in art and inspired him to become a collector. When he was 22, he scraped together 20,000 lire and knocked on De Chirico's door in the hope of buying a single drawing. The notoriously irascible artist was so impressed by the young Italian's tenacity that he allowed him to buy two, and a lasting relationship was born.

Mr Bilotti moved to New York in the 1960s and married the heiress to the Old Spice fragrance fortune. While building up the group, he became responsible for placing some of the first advertisements in Andy Warhol's *Interview* magazine. His support kept the fledgling magazine afloat and led to a friendship between the artist and collector that introduced Mr Bilotti to the new art of the day.

A picture gallery upstairs shows snapshots of Mr Bilotti and his wife with many of the artists whose work he has acquired, including Warhol, Roy Lichtenstein, Niki de Saint-Phalle and Larry Rivers. Mr Bilotti's connection with these artists and their work continues to this day: he remains friends with Willem de Kooning's daughter who is organising her father's first exhibition in Rome in the autumn. Mr Twombly, another friend, will show at the Bilotti next spring.

This is no small achievement for a tiny museum with no history in a city that has been out of the mainstream of contemporary art for centuries. But artists love to exhibit in Rome, Mr Bilotti says. The city's light, ambience and history help make everything look better; even Larry Gagosian, an influential New York dealer, is opening a gallery here.

As he walks through his museum, Mr Bilotti recalls each artist's comments and ideas. Some of the work on display is variable and a few pieces seem dated, but the collection reflects Mr Bilotti's enthusiasms rather than the prevailing taste in contemporary art. Even some of the most famous artists are represented by surprising work. Mr Hirst, for example, has four vast canvases devoted to the evangelists. Commissioned to decorate a disused chapel, they show a meditative, aesthetic side of the British artist that is rarely seen. Each is painted in rich, deep Rothko-like colours and studded with the vanitas emblems of Mr Hirst's work—butterflies and pills, and even a gold pen of Mr Bilotti's, a joking reference to the evangelists' writing and the patron's underwriting.

Mr Bilotti says that he wanted to give his paintings to the city of Rome as a tribute to a close friend, Walter Veltroni, the mayor who has done much to promote the city's cultural offerings. The collector's other goal was to offer young Italians something he never had while he was growing up: a chance to see contemporary art, which is sorely lacking in Italian museums that tend to be overloaded with Old Masters that they are not allowed to sell.

Many early collectors—including Sir Henry Tate, Paul Mellon and Henry Clay Frick—gave their art away. The new Pinault and Bilotti museums are largely filled with works that have been lent. Their central locations and the public backing they have received add a layer of burnishing to both enterprises; but these remain private collections. It is hard to avoid the whiff of self-interest that emanates from both the benefactors and the local politicians who are conjuring up instant new collections instead of investing in Italy's cultural infrastructure. Nonetheless, contemporary art is finally on the agenda in Italy—which can only be a good thing.

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About sponsorship

The Arab world

A woman's work is never done

May 25th 2006
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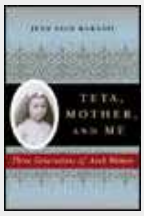
GIRLS just about everywhere are, or at least were, brought up to believe that their raison d'être is to provide comfort and sustenance for their menfolk and children. Whatever else was going on in the Arab world during the century and a quarter covered by these memoirs—and much was—Jean Said Makdisi, her mother and her grandmother (Teta) knew that their primary duty was to keep a clean, comfortable home, offering hospitality and shelter to family, friends and stray visitors, whatever the circumstances. Any other activity was peripheral. Her grandmother and mother obeyed the rules; Mrs Makdisi extricated herself, but only partially and it took Lebanon's war for her to do so.

Teta was born in 1880 in Syria which, in those Ottoman times, included Lebanon, Jordan and Palestine. The daughter of a Protestant pastor, she married a Baptist minister. Her granddaughter remembers her as a frail, stooping, ghost-like figure flitting about the house, obsessively neat, endlessly crocheting doilies and antimacassars. But this demotion occurred only after her widowhood. In her prime she had been a bustling matriarch who ran her house, husband and children with skill and determination but considered politics outside her realm—even though politics, during her lifetime, was to split historic Syria into nation-states and scatter the Palestinian people to the winds.

Teta, Mother, and Me: Three Generations of Arab Women
By Jean Said Makdisi



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Teta was determined that her children should be as well educated as she was and the answer, for a Protestant Arab family without much money, was the British and American mission schools which were happy to teach Christian Arab girls so that they should, in their turn, teach the next generation of mission schoolchildren. But the aim of all this admirable teaching was not to guide the women towards freedom, only to turn them eventually into better wives and mothers.

A few girls broke loose from the marriage trap, including the author's tiny, rumbustious great-aunt Emilia. A rebellious teacher, she quarrelled with the American missionaries in Beirut for their discrimination against “native” teachers—who were addressed as *Mualimie* (teacher) rather than Miss So-and-so, as the more honoured expatriates were—and then went on to co-found the first college in Egypt to offer women higher education. But Auntie Melia was a splendid exception.

Mrs Makdisi's much loved mother (whose education had been partly paid for by a generous Baptist, Mrs Bottoms of Texas) continually urged her daughters to be strong in carrying out their domestic duties and never to whine. And Jean herself, born during the second world war, was an obedient girl, enjoying an upper-class life in Egypt and Lebanon after the family home in Jerusalem was taken over by Israel. As her brother, the late Edward Said, has described in his own memoirs, their father was an American citizen who had been pulled back to his Palestinian homeland by his mother's deathbed wish. She writes of her gifted elder brother with affection—she was his ball girl at tennis and turned the pages when he played the piano—but briefly: this is a book about women.

Mrs Makdisi was sent to Vassar, where her main, less-than-noble political activity was taking part in a strike against “white meals”, ie, food smothered in white sauce. After marriage, she spent ten years experiencing what she describes as the arid, claustrophobic life of prosperous American middle-class women in suburban Washington, DC. When her husband was called back to Lebanon, she began teaching at Beirut University College but still felt, as her mother and grandmother had before her, that her main object in life was to serve her family.

The Lebanese civil war, she writes, offered her a “passport out of the isolation of middle-class domestic life”. She wrote a well-received book about the war and now watches, with admiration, as her three daughters-in-law seem much defter than she was in juggling family and career—although it is probably pretty tricky for them too.

Teta, Mother, and Me: Three Generations of Arab Women.
By Jean Said Makdisi.
Norton; 384 pages; $25.95. Saqi Books; £15.99

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About sponsorship

The power of the Pentagon

Wrestling with demons

May 25th 2006
From The Economist print edition

“IT IS all America's fault” is a familiar refrain. But is it all the fault of one building in America? The supposed cosmic connection between the date of the ground-breaking ceremony for the Pentagon, September 11th 1941, and the terrorist attacks on New York and Washington, DC 60 years later, provides the overarching theme for this rambling and unashamedly personal polemical account of America's engagement with the world. From the strategic bombing campaigns of the second world war, and the dropping of the atom bomb on Hiroshima and Nagasaki, to the present, James Carroll detects an unstoppable momentum, emanating from the Pentagon, towards total war. The author makes no apologies for his hyperbole and claims that his book is unerringly factual. But even facts need context.

Reuters

Extreme points of view

House of War: The Pentagon and the Disastrous Rise of American Power
By James Carroll

Houghton Mifflin; 672 pages; $30

Buy it at
Amazon.com
Amazon.co.uk

The book's less controversial claims concern the building itself: from its accidental location and design, to the amount of sand dredged from the Potomac to build it. For all the criticisms he heaps on the Pentagon and its “militarisation of America”, Mr Carroll has one good thing to report: the “house of war” was for many years the only place in Virginia not to have segregated toilets for blacks and whites.

From those down-to-earth beginnings, the book moves to shakier ground as it goes on to tell two intertwined stories. One is the evolution of America as a world power, about which Mr Carroll has lots, but nothing good, to say after its birth “in mortal sin”. The other is of his own increasingly strained relations with his father, for a number of years a senior occupant of the house of warmongers.

Interspersed with disquisitions on evil are Mr Carroll's explanations of his own sense of guilt that somehow his support for the peace movement in the 1960s contributed to his father's professional downfall. Whether these mawkish interludes work as catharsis only the author can tell. But does the rest of the book tell the reader a useful story?

Dwight Eisenhower mused famously and anxiously about the concentration of bureaucratic and military muscle in the wider “military-industrial complex”. Mr Carroll detects a deeper problem: the man who supervised the construction of the Pentagon also managed the programme to build America's first atomic bombs. This link between the absolute weapon and the absolute building, he argues, helped turn the Pentagon into a power centre “broken loose from the checks and balances of the government across the river”.

Then there is what Mr Carroll sees as the Pentagon's need for enemies, an impulse that helped to persuade America to see the Soviet threat in apocalyptic terms and one that has come full circle now that the “defined threat is Islam once again”. That is a cheap shot. Whether you like his way of going about it or not, George Bush's choice of enemy is suicidal terrorists operating in the name of radical Islam—and not the religion itself.

But what of America and the Soviet Union? Just as Mr Carroll explains German bombing of Britain in the second world war as retaliation—the sort, presumably, that you get in first—so he portrays Stalin's Russia as a largely

hapless victim of American militarism, despite the blockade of Berlin, the claiming of satellites in Eastern Europe and Stalin's nod to Kim Il Sung at the start of the Korean war. Against the backdrop of a recent global war against another tyranny, to use Mr Carroll's own facts, is it surprising that Eisenhower could not trust a country whose military commander cleared an inconvenient minefield in Berlin by having his own troops march across it?

The failure of successive American disarmament proposals (their authors presumably having temporarily slipped their Pentagon leash) is, meanwhile, put down entirely to the cowardice, hypocrisy or stupidity of successive presidents. Why then was the first real nuclear arms-cutting agreement reached only once Mikhail Gorbachev had slapped down his generals? Mr Carroll does not explain. For arms-control, let alone disarmament, to work, it was the nature of the Russian regime, not the American one, that had to change.

Mr Carroll seems to have plenty of personal demons to wrestle with. It is a pity he has done so by projecting them on to, and then distorting, other people's history.

House of War: The Pentagon and the Disastrous Rise of American Power.
By James Carroll.
Houghton Mifflin; 672 pages; $30

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About sponsorship

Meteorology

Radiantly cloudy

May 25th 2006
From The Economist print edition

CLOUDS have had few friends. A metaphor for sadness and confusion, they have long been seen as spoiling the weather, rather than being one of its most lovable and interesting aspects.

Now a fondly compiled compendium of the nebulous world's facts and fancies redresses the balance. The author, Gavin Pretor-Pinney, is the founder of the Cloud Appreciation Society, and aims to convert even the most sun-loving reader. He introduces the half-dozen main types of clouds as if they were his oldest friends: there is the towering, thunderous cumulonimbus, the beautiful cirrus, the fluffy, fine-weather cumulus. Even dull, ponderous old stratus—basically fog-in-the-sky—gets a friendly mention.

When his head is not in the clouds, the author runs a magazine for dilettantes called the *Idler*. But his research for the book betrays a startling diligence. References abound to clouds in history, art and literature. “The Birds”, a play by Aristophanes, is cited to illustrate stratocumulus, those clouds that look so tantalisingly like a magic country in the sky. He reproduces Andrea Mantegna's magnificent “Martyrdom of St Sebastian”, which dates from the 15th century, not for the striking image of the arrow-pierced saint, but as one of the first pictorial depictions of a cloud (though the artist muddles his cumulus and cirrus).

The cultural, scientific and biographical references are interwoven in a whimsical style that readers may find either infuriating or captivating. But they certainly serve to enliven what a more leaden pen would turn into a schoolroom exercise of memorisation and lexicography. After a few chapters, the reader is delighted to learn that there are four types of cirrus (intortus, radiatus, vertebratus and duplicatus).

A pilot's account of a high-altitude parachute descent through a thunderstorm is gripping. So is the search for the “Morning Glory”—a rare, rotating tubelike cloud best seen in remote northern Australia. Plain old sunshine seems dull in comparison.

The Cloudspotter's Guide: The Science, History and Culture of Clouds.
By Gavin Pretor-Pinney.
Perigee; 304 pages; $19.95. Sceptre; £12.99

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About sponsorship

Irish letters

Word made flesh

May 25th 2006 | DUBLIN
From The Economist print edition

How Ireland celebrates its writers

"IF YOU like books, there's plenty to see in Dublin", says the Townie to the Tourist. This advice is not as comical as it may sound. Irish writers have long been absorbed into the fabric of the city's flourishing tourist trade. Young visitors who have never read a word of "Ulysses" pose for their picture standing by the James Joyce statue on O'Connell Street. Funds from the European Union helped organise and open the James Joyce Centre and the Dublin Writers Museum.

April was dedicated to Samuel Beckett's centennial. Like Joyce, Beckett was an exile from the theocracy and censorship of Dublin in the first decades of the 20th century. Presently, a celebration is under way of Flann O'Brien's ingenious novel "At Swim-Two-Birds", which treats Irish history and literature as a fit subject for farce.

On May 25th, however, these fine and funny writers found themselves in the shade of the *capo di tutti i capi*, W.B. Yeats, the polymath's polymath. His biographer Roy Foster describes Yeats as "a poet, playwright, political agitator, journalist, theatre-manager, lover, committee-man, who was capable of writing magnificent letters". For the next two years, the National Library of Ireland is mounting the first comprehensive exhibition of Yeats's life and work drawn from its own collection of more than 2,000 items in 100 boxes—the largest collection of Yeats manuscripts in the world. Besides the poems and plays, letters and speeches are his tax returns, a lock of his grey hair, his signet ring and his spectacles.

Yeats's son Michael, an Irish senator like his father, had been asked to open the exhibition as a way of honouring him as the person principally responsible for the riches of the archive. Although the Yeats estate still benefits from reproductions of the master's poetry, over a period of 45 years Mr Yeats has given most of his father's archive and his books to the National Library. "If they'd put the papers on the open market, they'd all be multi-millionaires," says Catherine Fahy, one of the curators.

Yeats, like Joyce and Beckett, was an outsider in his own country—a Protestant who disdained narrow-minded Irish nationalism. Some of his ideas now seem distinctly unsympathetic, such as his flirtation with fascism in the 1930s, and his fondness for eugenics. One letter on show is a reply to a query from Yeats to the Eugenics Society. No, it says, there is no evidence that the leisured class have higher IQs than people who work for a living.

The letter can be read easily by touching the right spot on a screen by the display case. This is a high-tech show. Pages of rare books can be turned digitally; a book he gave to his wife is inscribed "Not to be taken by me" and signed "W.B. Yeats".

Of course, Yeats loved the Irish landscape: "I will arise and go now, and go to Innisfree" is perhaps his most famous opening line. Because that poem still resonates so strongly, the exhibition opens with a large colour photograph of the Lake Isle of Innisfree. Ms Fahy suggests that, 67 years after his death, Yeats has finally been embraced into the nation's folk memory: "Nationalist Ireland has got over its crisis about Yeats," she says. The process is eased by the decline of strident nationalism, and by the assimilation of Yeats into the Celtic tiger's tourist trade.

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About sponsorship

New fiction

Flights of hope

May 25th 2006
From The Economist print edition

MIGRATORY birds flutter through Brad Kessler's elegant new novel, an avian metaphor for the strength of the human spirit. This slow-burning meditation on grief and survival is also a re-telling of the Greek myth of Ceyx and Alcyone, a devoted couple whom the gods turned into seabirds.

One night, off the coast of Nova Scotia an aeroplane spirals into the sea killing all on board. Soon after, grieving relatives, their lives irrevocably changed, gather at the Trachis Inn near the crash site to wait for news of the dead. Here, under an umbrella of kindness unfurled by Kevin Gearns, the innkeeper, they form a close-knit yet disparate community, each of them thrown by tragedy into the orbit of the others, all of them searching for comfort. An Iranian refugee mourns the loss of his niece and consoles himself with centuries-old stories from his homeland; a Taiwanese couple offer fruit to the ghost of their daughter; a wordless Bulgarian plays a nocturne to his dead wife in the dark.

Birds in Fall
By Brad Kessler

Scribner; 238 pages; $24

Buy it at
Amazon.com
Amazon.co.uk

Central to the story is Ana Gathreaux, a migratory bird biologist, whose husband Russell, an ornithologist, was on the plane. Through Ana, the author explores the long reach of grief: the initial shock and disbelief, the desperate attempts to turn back the clock, the absurdity of normal life in abnormal circumstances. “Somehow to change her clothes, to shower (even to eat) seemed a kind of betrayal, an acceptance; and if she could only ignore the exigencies of her own body, she might outwit the deadly hours that kept slipping past.”

Softening the harshness of death is the theme of migration with which Mr Kessler underpins his narrative: the plane's passengers migrating from life to death; the resilience of migratory birds as proof of life's continuity; the bereaved migrating to the crash site. “How is a story like a bird?” the author asks. “It keeps us aloft. It flies. But its movements are carefully choreographed, and if you look closely, you'll know exactly where it will next perch.”

Birds in Fall.
By Brad Kessler.
Scribner; 238 pages; $24

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About sponsorship

Stanley Kunitz

May 25th 2006
From The Economist print edition

Stanley Kunitz, American poet, died on May 14th, aged 100

AP

IN A very long life, Stanley Kunitz did not seem to move around much. Apart from a spell in Pennsylvania in the 1930s and a lecture tour of the Soviet Union in 1967, he spent almost all his days in New York or New England, and most of those in Massachusetts. A line drawn through Worcester, Cambridge and Provincetown, in Cape Cod, where he grew roses in the Atlantic blasts, could neatly contain his world.

Yet Mr Kunitz was a poet, one of America's best of the past century, and therefore travelled incessantly. Much of the time he was on the sea, voyaging to the ends of the earth. In imagination he “strode years; stretched into bird;/ Raced though the sleeping country where I was young.” He could sink deep into his own mind, through gorges and ravines, “from the known to the unknown to the unknowable”. Or he could coil through life like a fish in a river.

> If the water were clear enough,
> if the water were still,
> but the water is not clear,
> the water is not still,
> you would see yourself,
> slipped out of your skin,
> nosing upstream,
> slapping, thrashing,
> tumbling
> over the rocks

This transformation happened as he read about the Pacific salmon in *Time*. The words began to flow, and he followed them. His sense of poetry-making—and few could explain so well the mysteries of it—was an almost animal instinct. As soon as he could feel his own “interior rhythm” in what he observed, whether slithering fish or falling leaf, he knew the poem would work.

His own rhythm took time to discover. Robert Herrick's songs, recited unexpectedly by a teacher at high school, first drew him into poetry; but it was Gerald Manley Hopkins's “God's Grandeur”, pulled down by chance from a shelf in a Harvard library, that showed Mr Kunitz the scope of what he could write. Over the years he moved from Elizabethan high style to simple, almost conversational free verse, “wringing out the water”, as he put it, and aiming for a poetry that was natural, luminous, deep and spare.

That was difficult, because Mr Kunitz felt his human heaviness so intensely. When a whale beached itself at Wellfleet, Massachusetts, he made it a metaphor of himself, “crushed by your own weight,/ collapsing into

yourself...disgraced and mortal." In his first collection, "Intellectual Things" (1930), he dreamed of stripping "The tender blanket from my bone" and rising "like a skeleton in the sun", but did not have much faith he would.

Nor, despite Hopkins, did he write about God. The "Father" he invoked in his poems was his own, who had killed himself before he was born. He had drunk carbolic acid in a park in Worcester, leaving Stanley's mother to support her children by dressmaking. Mr Kunitz followed this ghost obsessively: across the bloody grass, through plum orchards, to the edge of a river, where

> Among the turtles and the lilies he turned to me
> The white ignorant hollow of his face.

He wrote frequently of family, but almost never of his Jewishness. When rebuked for that, Mr Kunitz, who had been barred as a Jew from teaching at Harvard in 1927, made a sharp reply: "I am an American free-thinker, a damn stubborn one, and my poetry is not hyphenated." His rebelliousness showed again when he insisted on being a conscientious objector during the second world war; it showed, too, in his refusal to write fashionable stuff. To be a metaphysical poet entranced with nature, rather than a cynical observer of men and cities, was the wrong flavour for the mid-20th century. Mr Kunitz paid for his contrarian streak by being dismissed as too abstract and ignored by the critics. Had Theodore Roethke and Robert Lowell not befriended him, he might have stayed as sunk in pastoral obscurity as John Clare, and perhaps as mad.

Two hits on the tree

Loneliness seemed engrained in him. Out of school, his childhood was spent by himself in the woods throwing stones at a tree (two hits, he would be a poet), or testing how far he could climb up a perpendicular cliff. Later in life he kept the usual poet's habits, shut up by himself, writing in scrupulously neat longhand with no deletions. Every decade or so, a book of poems would appear. Very gradually, out of this slim oeuvre, a reputation grew and prizes came. In 2000, at the age of 95, he was made poet laureate of the United States.

Yet the lonely, searching poet could also be almost gregarious. He loved teaching, at Bennington, Yale and elsewhere, persuading his students, he said once, that every one of them could be a poet. He set up two centres, in Provincetown and New York, where writers could live and work in company with other artists, discussing their explorations.

As for his own endless travelling, each poem hinted at an end to it. "I have the sense", he said, "of swimming underwater towards some kind of light and open air that will be saving." Or,

> Becoming, never being, till
> Becoming is a being still.

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Overview

May 25th 2006
From The Economist print edition

Most **stockmarkets** continued to slide during the week, virtually wiping out their gains since the start of this year. Since early May, the big European markets have lost almost 10% of their value. In contrast, America's Dow Jones Industrial Average has fallen by only 5%.

American **Treasury-bond yields** dipped below 5%, down from 5.2% a week earlier, after new figures showed an unexpectedly large drop of 4.8% in durable-goods orders in April.

Japan's GDP growth slowed to an annual rate of 1.9% in the first quarter, but that still produced robust growth of 3.1% compared with a year ago. Better still, all of the growth in the quarter came from domestic demand.

Germany's GDP growth was confirmed at an annualised 1.6% in the first quarter. However, consumer spending rose at a robust annual pace of 2.4%. The Ifo survey of business confidence fell slightly in May but, according to JPMorgan, it is still consistent with GDP growth quickening to 3% in the second quarter. **French** GDP rose at an annual rate of 2.2% in the first quarter.

The **euro area's** 12-month trade surplus fell to only $6.7 billion in March, down sharply from $73.2 billion a year earlier.

British retail sales have picked up over the past few months, growing by 3% in the year to April.

The **world economy** quickened in the first quarter of 2006, according to *The Economist's* **GDP** indicator. Provisional estimates suggest GDP rose by 5.2% in the year to the first quarter, up from 4.9% in the fourth.

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Output, demand and jobs

May 25th 2006
From The Economist print edition

% change on year ago

	GDP latest		GDP qtr*	The Economist poll GDP forecasts 2006	2007	Industrial production latest		Retail sales (volume) latest		Unemployment % rate latest		year ago
Australia	+ 2.7	Q4	+ 1.9	+ 3.2	+ 3.4	+ 0.6	Q4	+ 2.7	Q1	5.1	Apr	5.1
Austria	+ 2.8	Q1	+ 2.0	+ 2.2	+ 1.9	+ 6.3	Feb	+ 2.4	Feb	4.8	Apr	5.1
Belgium	+ 2.2	Q1	+ 3.2	+ 2.2	+ 1.9	+ 7.1	Mar	– 1.9	Feb	12.1	Apr†	12.3
Britain	+ 2.2	Q1	+ 2.6	+ 2.4	+ 2.5	+ 0.3	Mar	+ 3.0	Apr	5.2	Mar‡	4.7
Canada	+ 2.9	Q4	+ 2.5	+ 3.1	+ 2.8	+ 1.4	Feb	+ 3.0	Feb	6.4	Apr	6.8
Denmark	+ 3.3	Q4	– 0.1	+ 2.8	+ 2.2	+ 7.1	Mar	+ 5.4	Mar	4.8	Mar	6.0
France	+ 1.5	Q1	+ 2.2	+ 2.0	+ 2.0	+ 1.9	Mar	+ 1.6	Mar	9.5	Mar	10.1
Germany	+ 1.4	Q1	+ 1.6	+ 1.8	+ 1.2	+ 3.9	Mar	– 1.2	Mar	11.3	Apr§	11.9
Italy	+ 1.5	Q1	+ 2.4	+ 1.2	+ 1.1	+ 4.2	Mar	+ 0.1	Feb	7.7	Dec	7.9
Japan	+ 3.1	Q1	+ 1.9	+ 3.0	+ 2.4	+ 3.1	Mar	– 0.2	Feb	4.1	Mar	4.5
Netherlands	+ 2.9	Q1	+ 0.7	+ 2.5	+ 2.0	+ 2.3	Mar	+ 4.6	Feb	5.7	Apr††	6.7
Spain	+ 3.5	Q1	+ 3.3	+ 3.2	+ 2.8	+10.9	Mar	+ 1.2	Mar	8.7	Mar	9.9
Sweden	+ 2.9	Q4	+ 2.6	+ 3.4	+ 2.8	+ 0.4	Mar	+ 5.1	Mar	5.5	Apr†	5.8
Switzerland	+ 2.7	Q4	+ 2.1	+ 2.3	+ 1.8	+ 3.9	Q4	+ 0.7	Mar	3.5	Apr†	3.8
United States	+ 3.5	Q1	+ 4.8	+ 3.4	+ 2.8	+ 4.7	Apr	+ 6.2	Mar	4.7	Apr	5.1
Euro area	+ 2.0	Q1	+ 2.4	+ 2.1	+ 1.7	+ 3.8	Mar	– 0.2	Mar	8.1	Mar	8.8
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 2.8	Q1	+ 1.6	na	na	+ 3.7	Mar	+ 6.2	Mar	7.5	Apr	8.6
Greece	+ 4.1	Q1	na	na	na	+ 1.7	Mar	+ 5.9	Feb	9.7	Q4	10.4
Iceland	+ 3.6	Q4	na	na	na	na		na		1.6	Feb†	2.8
Ireland	+ 5.7	Q4	+ 7.6	na	na	+ 1.8	Mar	+ 5.3	Mar	4.5	Apr	4.3
Luxembourg	+ 5.7	Q4	na	na	na	+ 6.3	Feb	+ 7.6	Mar	4.6	Mar	4.1
New Zealand	+ 1.9	Q4	nil	na	na	– 2.9	Q4	+ 3.0	Q1	3.9	Q1	3.9
Norway	+ 2.5	Q4	+ 1.0	na	na	+ 1.6	Mar	+ 7.7	Mar	3.9	Mar**	4.6
Portugal	+ 0.7	Q4	+ 0.4	na	na	+ 4.8	Mar	– 0.1	Mar	8.0	Q4†	7.1

*% change on previous quarter at an annual rate. †Not seasonally adjusted. ‡Jan-Mar; claimant count rate 3.0% in Apr. §EU harmonised rate 8.7% in Mar. ††Feb-Apr. **Jan-Mar.

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Prices and wages

May 25th 2006
From The Economist print edition

% change on year ago

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2006	2007	latest		year ago	latest		year ago
Australia	+ 3.0	Q1	+ 2.4	+ 2.9	+ 2.7	+ 7.9	Q1	+ 6.0	+ 4.0	Q1	+ 4.5
Austria	+ 1.8	Apr	+ 2.6	+ 1.8	+ 1.8	+ 2.4	Apr	+ 2.6	+ 2.7	Apr	+ 2.2
Belgium	+ 2.0	Apr	+ 2.8	+ 2.1	+ 1.8	+ 4.1	Mar	+ 3.8	+ 2.2	Jan	+ 2.3
Britain	+ 2.0	Apr*	+ 1.9	+ 2.0	+ 1.9	+ 2.4	Apr	+ 3.3	+ 4.2	Mar†	+ 4.5
Canada	+ 2.4	Apr	+ 2.4	+ 2.2	+ 2.1	+ 1.1	Mar	+ 2.6	+ 0.8	Feb	+ 2.8
Denmark	+ 1.8	Apr	+ 1.8	+ 1.9	+ 1.9	+ 5.0	Apr	+ 3.8	+ 2.9	Q4	+ 2.9
France	+ 1.7	Apr	+ 1.8	+ 1.8	+ 1.5	+ 3.3	Mar	+ 3.2	+ 3.3	Q1	+ 2.9
Germany	+ 2.0	Apr	+ 1.6	+ 1.6	+ 2.3	+ 3.2	Apr	+ 3.2	+ 0.3	Mar	+ 1.5
Italy	+ 2.2	Apr	+ 1.9	+ 2.1	+ 1.8	+ 4.5	Mar	+ 4.8	+ 2.7	Mar	+ 3.5
Japan	+ 0.3	Mar	− 0.2	+ 0.4	+ 0.6	+ 2.5	Apr	+ 1.9	− 0.6	Mar	+ 1.3
Netherlands	+ 1.2	Apr	+ 1.5	+ 1.5	+ 1.5	+ 4.9	Mar	+ 5.3	+ 1.8	Apr	+ 0.5
Spain	+ 3.9	Apr	+ 3.5	+ 3.5	+ 2.9	+ 5.7	Apr	+ 5.0	+ 2.5	Q4	+ 2.7
Sweden	+ 1.5	Apr	+ 0.3	+ 1.2	+ 1.8	+ 4.7	Apr	+ 2.7	+ 2.8	Feb	+ 2.7
Switzerland	+ 1.1	Apr	+ 1.4	+ 1.1	+ 1.2	+ 1.9	Apr	+ 1.3	+ 1.0	2005	+ 0.9
United States	+ 3.5	Apr	+ 3.5	+ 3.1	+ 2.4	+ 4.0	Apr	+ 4.8	+ 3.8	Apr	+ 2.7
Euro area	+ 2.4	Apr	+ 2.1	+ 2.0	+ 2.0	+ 5.3	Mar	+ 4.2	+ 2.4	Q4	+ 2.4
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 1.3	Apr	+ 1.2	na	na	+ 6.1	Apr	+ 3.1	+ 3.5	Q4	+ 4.3
Greece	+ 3.3	Apr	+ 3.4	na	na	+ 7.8	Mar	+ 4.7	na		na
Iceland	+ 7.6	May	+ 2.9	na	na	+ 6.9	May	+ 4.5	+ 8.4	Apr	+ 6.7
Ireland	+ 3.8	Apr	+ 2.2	na	na	+ 3.6	Mar	− 2.3	+ 3.8	Q4	+ 4.6
Luxembourg	+ 2.9	Apr	+ 2.5	na	na	+ 4.1	Mar	+15.2	+ 5.6	Feb	+ 0.4
New Zealand	+ 3.3	Q1	+ 2.8	na	na	+ 7.2	Q1	+ 4.2	+ 3.3	Q1	+ 2.5
Norway	+ 2.7	Apr	+ 1.3	na	na	+20.6	Apr	+17.5	+ 3.1	Q4	+ 3.9
Portugal	+ 2.9	Apr	+ 2.1	na	na	+ 4.8	Apr	+ 4.4	+ 1.1	Mar	− 3.9

*RPI inflation rate 2.6% in Apr. †Jan-Mar.

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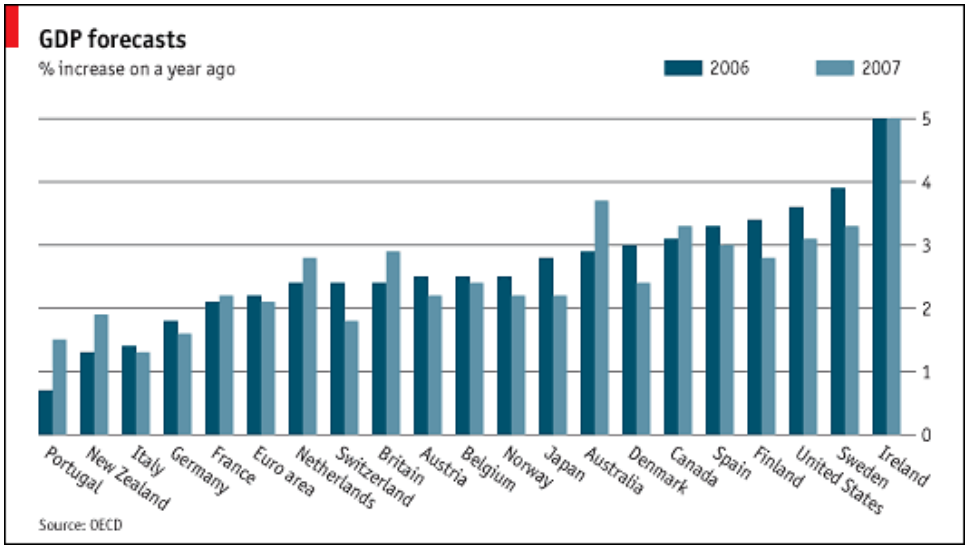
GDP forecasts

May 25th 2006
From The Economist print edition



America and Japan will enjoy solid growth this year, falling slightly in 2007, according to the OECD's latest economic forecasts. But a number of countries, including Portugal, New Zealand, the Netherlands, Britain and Australia can look forward to faster growth next year. In Portugal and New Zealand the recovery will be led by exports, which might grow as fast as 5.6% and 9.2% respectively in 2007, the OECD said.

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About sponsorship

Money and interest rates

May 25th 2006
From The Economist print edition

	Money supply* % change on year ago			Interest rates % p.a. (May 24th 2006)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	+10.4	+ 9.1	Mar	5.87	5.68	5.62	5.68	5.20	6.68
Britain	+ 7.5	+13.1	Apr	4.64	4.81	4.68	4.57	4.31	5.10
Canada	+11.7	+ 6.8	Mar	4.08	2.47	4.10	4.34	4.09	5.54
Denmark	+12.8	+10.5	Apr	2.95	2.18	3.39	3.88	3.27	5.19
Japan	+ 5.1	+ 1.7	Apr	0.10	0.02	0.73	1.85	1.23	1.90
Sweden	- 0.5	+10.9	Mar	2.12	1.86	2.91	3.71	3.22	3.57
Switzerland	+ 3.1	+ 4.6	Apr	1.41	0.75	1.86	2.68	2.01	2.61
United States	+ 1.9	+ 4.9	Apr‡	5.06	3.17	4.92	5.05	4.09	6.05
Euro area†	+10.1	+ 8.6	Mar	2.91	2.13	3.24	3.83	3.21	4.35

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. †Germany for bonds. ‡New series for broad money supply. Benchmarks: US 30-year 5.13%, Japan No. 279 1.82%. Central bank rates: US fed funds 5.00%, ECB refinancing 2.50%, BOJ overnight call 0.001%, BOE repo 4.5%. Sources:Bank of Canada, Commerzbank, Danske Bank, Global Insight, JPMorgan Chase, Stockholmsbörsen, UBS, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

May 25th 2006
From The Economist print edition

2000=100

	May 16th	May 23rd*	% change on one month	% change on one year
Dollar index				
All items	182.2	178.6	+ 4.3	+ 34.1
Food	139.7	138.9	+ 2.1	+ 7.4
Industrials				
All	237.3	229.9	+ 6.0	+ 66.5
Nfa†	156.8	157.7	+ 5.6	+ 21.7
Metals	281.1	269.2	+ 6.1	+ 88.7
Sterling index				
All items	146.5	143.8	- 1.0	+ 30.3
Euro index				
All items	131.2	128.5	+ 0.7	+ 31.3
Yen index				
All items	186.1	184.4	+ 1.1	+ 38.9
Gold				
$ per oz	689.00	668.30	+ 6.0	+ 59.9
West Texas Intermediate				
$ per barrel	69.28	71.25	- 1.4	+ 43.6

*Provisional. †Non-food agriculturals.

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Stockmarkets

May 25th 2006
From The Economist print edition

Market indices

	May 24th	2006 high	2006 low	% change on one week	% change on record high	% change on Dec 30th 2005 in local currency	% change on Dec 30th 2005 in $ terms
Australia (All Ordinaries)	4,995.0	5,318.2	4,708.8	– 3.4	– 6.1	+ 6.1	+ 8.7
Austria (ATX)	3,655.1	4,344.4	3,559.0	– 6.5	– 15.9	– 0.3	+ 7.8
Belgium (Bel 20)	3,640.2	3,987.3	3,568.0	– 1.4	– 8.7	+ 2.6	+11.0
Britain (FTSE 100)	5,587.1	6,132.7	5,532.7	– 1.6	– 19.4	– 0.6	+ 8.1
Canada (Toronto Composite)	11,423.9	12,487.3	11,272.3	– 1.9	– 8.5	+ 1.3	+ 5.2
Denmark (OMXCB)	349.7	395.5	345.8	– 4.0	– 11.6	– 4.9	+ 2.9
France (SBF 250)	3,419.1	3,755.6	3,327.6	– 1.6	– 22.1	+ 3.6	+12.1
France (CAC 40)	4,870.0	5,312.2	4,748.3	– 1.0	– 29.6	+ 3.3	+11.7
Germany (DAX)*	5,587.2	6,140.7	5,334.3	– 1.2	– 30.7	+ 3.3	+11.8
Italy (S&P/MIB)	35,672.0	38,765.0	35,264.0	– 2.2	– 28.8	– 0.1	+ 8.1
Japan (Nikkei 225)	15,907.2	17,563.4	15,341.2	– 2.5	– 59.1	– 1.3	+ 3.4
Japan (Topix)	1,606.0	1,783.7	1,572.1	– 3.1	– 44.3	– 2.7	+ 2.0
Netherlands (AEX)	435.8	478.0	428.8	– 0.1	– 37.9	– 0.2	+ 8.0
Spain (Madrid SE)	1,199.2	1,318.5	1,156.8	– 2.3	– 9.0	+ 3.7	+12.2
Sweden (Affarsvarlden Gen)	291.3	333.7	281.5	– 3.4	– 27.2	– 0.7	+ 8.3
Switzerland (Swiss Market)	7,481.3	8,122.1	7,430.2	– 2.3	– 11.1	– 1.4	+ 6.7
United States (DJIA)	11,117.3	11,642.7	10,667.4	– 0.8	– 5.2	+ 3.7	+ 3.7
United States (S&P 500)	1,258.6	1,325.8	1,248.3	– 0.9	– 17.6	+ 0.8	+ 0.8
United States (NASDAQ Comp)	2,169.2	2,370.9	2,158.8	– 1.2	– 57.0	– 1.6	– 1.6
Europe (FTSEurofirst 300)†	1,284.3	1,405.6	1,271.5	– 2.0	– 24.7	+ 0.7	+ 8.9
Euro area (FTSE Euro 100)†	1,099.3	1,198.7	1,078.9	– 1.1	– 29.1	+ 0.9	+ 9.2
World (MSCI)‡	1,306.6	1,406.3	1,259.1	– 2.2	– 9.8	+ 3.9	+ 3.9
World bond market (Citigroup)††	642.7	646.7	612.1	– 0.2	– 3.6	+ 3.6	+ 3.6

*Total return index. †In euro terms. ‡Morgan Stanley Capital International index includes individual markets listed above plus eight others, in $ terms. ††Citigroup World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

May 25th 2006
From The Economist print edition

	Trade balance*, $bn latest 12 months	Current-account balance $bn latest 12 mths	Current-account balance The Economist poll % of GDP, forecast 2006	Current-account balance The Economist poll % of GDP, forecast 2007	Exchange rate trade-weighted† 2000=100 May 24th	Exchange rate trade-weighted† 2000=100 year ago	Currency units per $ May 24th	Currency units per $ year ago	Currency units per £	Currency units per euro	Currency units per ¥100	Budget balance % of GDP 2005‡
Australia	− 12.4 Mar	− 42.1 Q4	− 5.6	− 5.1	115.8	115.4	1.33	1.31	2.48	1.70	1.18	+ 1.5
Austria	− 2.0 Feb	+ 0.5 Dec	+ 0.1	+ 0.1	105.0§	106.0	0.78	0.79	1.46	–	0.70	− 1.6
Belgium	+ 11.1 Mar	+ 6.6 Dec	+ 2.0	+ 2.1	106.7§	108.0	0.78	0.79	1.46	–	0.70	− 0.1
Britain	−123.0 Mar	− 57.4 Q4	− 2.6	− 2.6	100.5	99.5	0.54	0.55	–	0.68	0.48	− 3.2
Canada	+ 59.7 Mar	+ 25.2 Q4	+ 2.3	+ 1.7	127.9	113.6	1.12	1.27	2.10	1.44	1.00	+ 1.7
Denmark	+ 8.9 Mar	+ 6.2 Mar	+ 2.5	+ 2.3	106.4	106.2	5.84	5.91	10.9	7.46	5.19	+ 4.0
France	− 28.8 Mar	− 43.6 Mar	− 1.8	− 1.6	107.4§	108.9	0.78	0.79	1.46	–	0.70	− 2.9
Germany	+191.5 Mar	+108.4 Mar	+ 3.8	+ 4.0	108.8§	110.5	0.78	0.79	1.46	–	0.70	− 3.3
Italy	− 17.6 Mar	− 28.5 Mar	− 1.6	− 1.5	107.0§	108.4	0.78	0.79	1.46	–	0.70	− 4.3
Japan	+ 84.7 Mar	+166.7 Mar	+ 3.7	+ 3.5	83.1	87.7	113	108	210	144	–	− 5.2
Netherlands	+ 39.5 Mar	+ 42.3 Q1	+ 5.7	+ 5.7	107.5§	108.8	0.78	0.79	1.46	–	0.70	− 0.3
Spain	− 99.9 Mar	− 85.6 Feb	− 7.0	− 6.9	105.3§	106.2	0.78	0.79	1.46	–	0.70	+ 1.1
Sweden	+ 19.3 Mar	+ 21.8 Q4	+ 6.4	+ 6.0	97.2	98.4	7.29	7.29	13.6	9.31	6.47	+ 2.7
Switzerland	+ 7.9 Apr	+ 50.2 Q4	+13.1	+12.4	107.2	107.3	1.22	1.23	2.27	1.55	1.08	− 0.5
United States	−806.1 Mar	−804.9 Q4	− 6.8	− 6.7	82.8	84.6	–	–	1.87	1.28	0.89	− 3.8
Euro area	+ 6.7 Mar	− 39.1 Feb	− 0.3	− 0.1	118.3	117.2	0.78	0.79	1.46	–	0.70	− 2.4
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 9.4 Mar	+ 3.8 Mar	na	na	108.3§	109.5	0.78	0.79	1.46	–	0.70	+ 2.4
Greece	− 35.0 Feb	− 21.4 Mar	na	na	104.3§	105.1	0.78	0.79	1.46	–	0.70	− 4.4
Iceland	− 1.7 Mar	− 2.6 Q4	na	na	105.7**	99.4	73.1	64.3	137	93.3	64.9	+ 3.2
Ireland	+ 38.1 Mar	− 3.9 Q4	na	na	112.2§	114.8	0.78	0.79	1.46	–	0.70	+ 1.0
Luxembourg	− 4.8 Feb	+ 3.6 Q4	na	na	106.7§	108.0	0.78	0.79	1.46	–	0.70	− 1.9
New Zealand	− 4.8 Apr	− 9.6 Q4	na	na	122.2	137.4	1.59	1.40	2.97	2.03	1.41	+ 5.8
Norway	+ 52.2 Apr	+ 49.5 Q4	na	na	112.3	108.6	6.13	6.40	11.4	7.82	5.44	+ 15.8
Portugal	− 23.1 Feb	− 17.0 Mar	na	na	105.3**	106.6	0.78	0.79	1.46	–	0.70	− 6.0

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †Bank of England except §IMF, March average. ‡OECD estimate. **IMF, January average.

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Small stockmarkets

May 25th 2006
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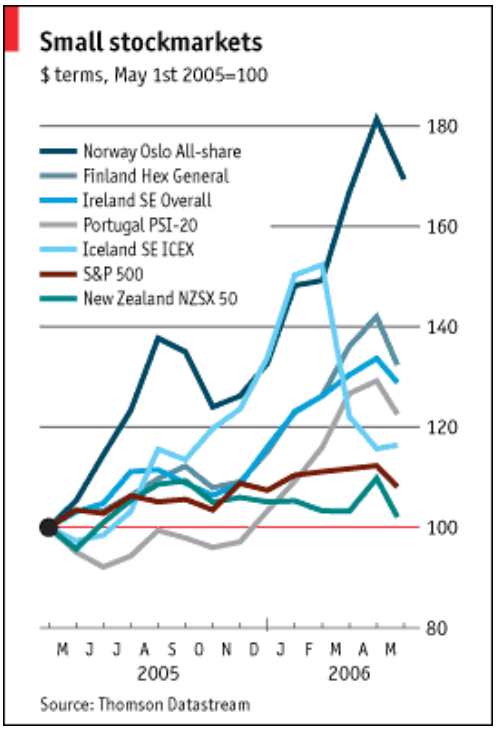

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Overview

May 25th 2006
From The Economist print edition

Hong Kong's economy grew faster than expected, by 8.2% in the year to the first quarter. Consumer-price inflation rose by 1.9% in the year to April.

Chile's GDP grew by 5.1% in the year to the first quarter, its slowest pace for two years.

Brazil's current-account surplus shrank to $12.8 billion in the year to April.

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Foreign debt

May 25th 2006
From The Economist print edition

Because it is only rarely denominated in their own currencies, foreign debt can be risky for developing countries. Such debt leaves borrowers exposed if exchange rates move against them. For their part, lenders worry when foreign debt is high as a share of GDP. By this standard, the burden continues generally to ease. It exceeds 50% of GDP in only a few economies in our table.

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Economy

May 25th 2006
From The Economist print edition

	% change on year ago						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+10.2	Q1	+16.6	Apr	+ 1.2	Apr	+114.1	Apr	+160.8	2005	875.1	Mar
Hong Kong	+ 8.2	Q1	+ 5.9	Q4	+ 1.9	Apr	−11.9	Mar	+20.3	Q4	127.0	Apr
India	+ 7.6	Q4	+ 7.7	Mar	+ 4.9	Mar	−39.4	Mar	−13.3	Q4	153.6	Apr
Indonesia	+ 4.6	Q1	+ 0.2	Mar	+15.4	Apr	+30.5	Mar	+ 3.0	Q4	38.3	Mar
Malaysia	+ 5.2	Q4	+ 3.6	Mar	+ 4.6	Apr	+26.7	Mar	+19.9	Q4	73.1	Mar
Pakistan	+ 8.4	2005†	+19.3	Sep	+ 6.2	Apr	−10.7	Apr	− 3.7	Q4	10.9	Mar
Philippines	+ 6.1	Q4	− 6.6	Mar	+ 7.1	Apr	− 3.6	Mar	+ 2.4	Dec	17.9	Apr
Singapore	+10.6	Q1	+25.2	Mar	+ 1.1	Apr	+33.2	Apr	+33.2	Q4	127.9	Apr
South Korea	+ 6.2	Q1	+10.0	Mar	+ 2.0	Apr	+18.8	Apr	+ 9.6	Mar	222.8	Apr
Taiwan	+ 4.9	Q1	+ 5.5	Apr	+ 1.2	Apr	+10.4	Apr	+18.1	Q1	259.0	Apr
Thailand	+ 4.7	Q4	+ 8.2	Mar	+ 6.0	Apr	− 5.9	Mar	− 0.7	Mar	53.7	Mar
Argentina	+ 9.1	Q4	+ 4.9	Apr	+11.6	Apr	+11.2	Mar	+ 5.4	Q4	20.5	Mar
Brazil	+ 1.4	Q4	+ 5.2	Mar	+ 4.6	Apr	+45.0	Apr	+12.8	Apr	59.2	Mar
Chile	+ 5.1	Q1	+ 7.6	Mar	+ 3.7	Apr	+12.1	Apr	+ 0.7	Q4	17.5	Apr
Colombia	+ 5.4	Q1	+ 5.6	Feb	+ 4.1	Apr	+ 1.4	Jan	− 1.9	Q4	14.9	Apr
Mexico	+ 5.5	Q1	+ 9.7	Mar	+ 3.2	Apr	− 4.9	Mar	− 5.7	Q4	76.0	Mar
Peru	+10.7	Mar	+ 9.8	Mar	+ 2.9	Apr	+ 5.2	Mar	+ 1.0	Q4	13.4	Mar
Venezuela	+ 9.4	Q1	+ 8.7	Feb	+11.4	Apr	+31.5	Q4	+28.1	Q1	22.5	Feb
Egypt	+ 5.9	Q1	+ 4.0	2005†	+ 3.7	Mar	−11.1	Q4	+ 2.2	Q4	22.0	Apr
Israel	+ 5.2	Q1	+ 6.6	Mar	+ 3.8	Apr	− 8.7	Apr	+ 2.4	Q4	28.0	Apr
Saudi Arabia	+ 6.2	2005‡	na		+ 1.6	Feb	+84.6	2004	+90.7	2005	28.1	Mar
South Africa	+ 4.5	Q4	+ 5.7	Mar	+ 3.3	Apr	− 5.0	Mar	−10.1	Q4	21.3	Apr
Czech Republic	+ 6.9	Q4	+17.9	Mar	+ 2.8	Apr	+ 1.7	Mar	− 2.6	Q4	30.2	Apr
Hungary	+ 4.5	Q1	+11.3	Mar	+ 2.3	Apr	− 3.4	Mar	− 8.0	Q4	20.5	Apr
Poland	+ 4.2	Q4	+10.2	Apr	+ 0.7	Apr	− 2.6	Mar	− 4.2	Mar	42.3	Mar
Russia	+ 7.0	Q4	+ 4.8	Apr	+10.0	Apr	+129.9	Mar	+84.3	Q1	225.7	Apr
Turkey	+ 9.5	Q4	+ 8.9	Mar	+ 8.8	Apr	−45.8	Mar	−25.5	Mar	55.9	Mar
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Estonia	+11.1	Q4	+ 6.8	Mar	+ 4.3	Apr	− 2.6	Feb	− 1.6	Mar	1.9	Mar
Latvia	+10.5	Q4	+ 9.9	Mar	+ 6.1	Apr	− 3.2	Mar	− 2.1	Mar	2.5	Mar
Lithuania	+ 8.1	Q1	na		+ 3.5	Apr	− 4.0	Mar	− 2.0	Mar	3.9	Mar
Slovakia	+ 6.3	Q1	+15.3	Mar	+ 4.5	Apr	− 2.8	Mar	− 4.2	Jan	15.9	Feb
Slovenia	+ 5.1	Q4	+ 9.9	Mar	+ 2.7	Apr	− 1.7	Mar	− 0.4	Mar	8.3	Feb

*Excluding gold, except Singapore and China; IMF definition. †Year ending June. ‡Economist Intelligence Unit estimate.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; Bank Leumi le-Israel; Standard Bank Group

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Financial markets

May 25th 2006
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	May 24th		Dec 30th 2005	
	May 24th	year ago	May 24th	% a year		one week	in local currency	in $ terms
China	8.03	8.28	15.0	2.57	1,670.9	– 2.1	+ 36.9	+ 37.6
Hong Kong	7.76	7.78	14.5	4.62	15,822.6	– 4.8	+ 6.4	+ 6.3
India	45.8	43.5	85.4	5.64	10,573.2	–13.5	+ 12.5	+ 10.7
Indonesia	9,360	9,478	17,476	13.10	1,323.1	– 9.5	+ 13.8	+ 19.6
Malaysia	3.64	3.80	6.80	3.92	927.8	– 3.2	+ 3.1	+ 7.0
Pakistan	60.2	59.5	112	9.40	11,116.9	+0.2	+ 16.3	+ 15.6
Philippines	52.9	54.4	98.7	8.19	2,252.6	– 8.6	+ 7.5	+ 7.8
Singapore	1.59	1.66	2.97	3.44	2,436.6	– 4.4	+ 3.8	+ 8.5
South Korea	950	1,001	1,773	4.36	1,333.4	– 4.9	– 3.3	+ 2.9
Taiwan	32.0	31.4	59.8	1.70	6,877.0	– 3.4	+ 5.0	+ 7.8
Thailand	38.6	40.1	72.0	5.30	714.1	– 6.3	+ 0.1	+ 6.4
Argentina	3.08	2.89	5.75	9.75	1,578.8	– 6.2	+ 2.3	+ 0.6
Brazil	2.34	2.41	4.36	15.67	35,791.0	– 6.5	+ 7.0	+ 6.9
Chile	532	580	994	4.92	9,874.9	– 3.0	+ 7.3	+ 3.2
Colombia	2,511	2,330	4,688	5.95	8,368.2	– 8.0	– 12.0	– 19.9
Mexico	11.3	10.9	21.1	7.01	18,805.6	– 7.2	+ 5.6	– 0.5
Peru	3.27	3.25	6.10	4.60	7,333.3	nil	+ 52.7	+ 60.3
Venezuela	2,565§	2,628§	4,788	10.52	30,243.0	– 1.9	+ 48.3	+ 49.5
Egypt	5.77	5.80	10.77	8.66	46,406.7	–11.1	– 16.2	– 16.6
Israel	4.53	4.39	8.45	5.56	867.8	– 4.8	+ 4.8	+ 6.6
Saudi Arabia	3.75	3.75	7.00	4.84	10,341.6	– 3.3	– 38.1	– 38.1
South Africa	6.63	6.52	12.4	7.15	20,014.3	– 3.1	+ 10.6	+ 5.9
Czech Republic	22.1	24.3	41.3	2.10	1,319.9	– 9.8	– 10.4	– 0.3
Hungary	206	202	384	6.12	20,901.8	– 8.7	+ 0.6	+ 4.5
Poland	3.11	3.33	5.80	4.16	39,393.3	– 8.5	+ 10.7	+ 15.9
Russia	27.0	28.0	50.4	12.00	1,368.5‡	–11.3	+ 14.3	+ 21.6
Turkey	1.55	1.39	2.89	14.22	36,100.7	–10.7	– 9.2	– 20.9
EM (MSCI)*	1.00	1.00	1.87	na	748.7	– 8.3	+ 6.0	+ 6.0
EMBI+†	1.00	1.00	1.87	na	364.2	– 0.7	– 1.2	– 1.2

*Emerging Mkts. †JPMorgan Chase's Emerging Mkts Bond Index Plus. ‡In $ terms. §Floating exchange rate.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; Bank Leumi le-Israel; Standard Bank Group

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